

## Twelve Pieces of Good News in the Gloom

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Few have had as many quotes attributed to them as Winston Churchill.

One of his expressions is especially relevant right now:  
“Pessimists see problems in every opportunity. Optimists see opportunities in every problem.”



These days, there’s certainly no shortage of difficulties– the only saving grace is that the vast majority of these problems appear to be priced into the market.

In fact, a strong case can be made that the pendulum has swung to the point of excess gloom. At a lecture I attended a few years back, a prominent professor of business history commented: “There has always been good news and bad news out there. Only two things vary at any given point in time: First the balance between good and bad news and second what people focus on.” The tech mania of 1998 to 2000 was a classic period in which we only focused on the good news and ignored the bad; arguably we’re seeing the opposite take place today as all that people talk about are the negatives, neglecting anything remotely positive.

For advisors looking to balance today’s bad news with some offsetting positives, here are twelve “good news stories” to consider:

### 1. Attractive market valuations

Depending on who you ask, stock valuations are generally seen to be at either normal historical levels (which should lead to returns in the 8 to 10% range) or at extremely attractive levels, which would result in returns well above that.

In a recent Advisor Perspectives [interview](#), Bruce Berkowitz, manager of the highly successful Fairholme mutual fund, said “Prices today are as attractive as I have seen in my career.” Berkowitz is a highly respected



value investor, and was chosen to write an introduction to the just released sixth edition of Graham and Dodd's classic text, *Security Analysis*.

One skeptic who has changed his views is Robert Schiller of Yale, who predicted both the tech collapse and US real estate meltdown – and now says that market valuations have returned to normalized levels.

And, as most advisors know, none other than Warren Buffett proclaimed in an October 17, 2008, [op-ed piece](#) in the New York Times, "Buy American. I am."

## **2. The impact of lower oil prices**

The dramatic drop in oil prices has put many more dollars in the pockets of businesses and individual consumers. No matter how dire economic prospects might appear, they'd be much worse if oil was still at \$150 (unless of course you happen to be employed in the oil patch – this is a classic example of the same news being positive for some and negative for others.)

## **3. A return to the old virtues among banks**

At one time, banks stood for prudence, risk management, oversight and transparency. It's clear that too many banks got away from these principles – and also clear that we're seeing a return to these traditional virtues that will ultimately leave the banking system stronger.

## **4. Strong political leadership around the world**

The challenges we're facing today will test the leadership of all of the major economies ... the good news is that it's difficult to remember a time when we had leadership that was stronger and more collaborative and open to new directions than we see today with Gordon Brown, Angela Merkel, Nicolas Sarkozy and Jean-Claude Trichet of the European Central Bank in Europe; Barack Obama, Ben Bernanke Tim Geithner, Paul Volcker and Larry Summers in the United States; and Hu Jintao in China and Manmohan Singh in India.

The early response to Obama's new administration is especially positive – as he and his team promise to boost confidence among American investors, consumers and businesses - confidence which has been sorely lacking over the recent period.



The sole exceptions to strong leadership among major powers are in Japan, which has suffered from a leadership vacuum since Junichiro Koizumi retired in 2006, and Vladimir Putin in Russia – while there is little question about his strength, his openness to new directions and willingness to collaborate is another question.

## **5. A coordinated global response by central bankers**

In the past, difficulties similar to today's would have led to a fractured and fragmented global response. That's a sharp contrast to the coordinated and cooperative response we've seen from central banks and the economic leadership in place today. Indeed, there appears to be a steadfast commitment to do whatever it takes to keep the financial system afloat and to provide the stimulus to get economic growth restarted.

## **6. Catching up on infrastructure**

Once agreement is reached that governments need to spend to help get their economies going again, the next question is what form that spending will take.

A number of options are being discussed. Increasingly, consensus is forming on using this opportunity to upgrade our infrastructure, just as happened in the 1930s. These investments are badly needed - providing this money is targeted correctly on upgraded transit, roads, bridges and airports that will ease congestion and improve productivity, we will see the payoff from this for decades to come.

## **7. A reality check on spending and saving**

Lots of headlines are proclaiming the dramatic drop in spending and “the new frugality” – and the potentially devastating effect on retailers in the period ahead.

The retailing industry is facing a shakeout over the next six to twelve months. But beneath the bleak news for retailers and for the manufacturers of the goods they sell is a more positive story. Over the past twenty years, many Western countries have seen a huge increase in indebtedness along with a dramatic drop in saving rates. Part of this stemmed from today's “I want it all and I want it now” mindset – and part from the view that appreciation in houses and in stocks would offset the failure to save.



Even though we're in the early days of the economic downturn, the shift in mindset to more balance between spending and saving appears to be more than a blip. While a painful adjustment for some in the short term, over time this will be a significant positive, as personal finances moved to a more stable and sustainable footing, capacity increases to absorb unanticipated setbacks related to health issues or employment and there is less reliance on public funding of retirement.

For more on this, see the New York Times column, [Dying of Consumption](#), by Stephen Roach, Chairman of Morgan Stanley Asia.

A deeper, potentially positive, meaning to the decline in consumer spending is that Americans are now moving back to more prudent income-based lifestyles.

## **8. Pruning of weak players**

The economist Joseph Schumpeter is best known for the concept of "creative destruction," the dynamic process whereby new ideas supersede old ones and innovation leads to the collapse of traditional market leaders. While it's intensely painful if you have the misfortune to work for or invest in one of these companies, a key reason that the U.S. dramatically outperformed every other major economy in the 20<sup>th</sup> century was its flexibility, adaptiveness and willingness to allow losers to die.

Whether in the automobile industry, retailing or banking, consumers will be better off and the economic system will be stronger when marginal players are consolidated into stronger survivors – setting the stage for new upstarts to emerge and challenge the remaining incumbents. In the U.S., France, Germany and the United Kingdom, an important byproduct of recent events is that weaker banks have disappeared from the scene, with the surviving banks becoming stronger as a result.

## **9. Opening of economies and growth of entrepreneurial drive**

We've all heard the expression "you can't put the genie back in the bottle." In the past ten years, we have seen a remarkable outpouring of entrepreneurial spirit and energy in countries with historically closed economies, ranging from China, India and Vietnam to Eastern Europe and South America.

While the current economic downturn represents a setback, a fierce work ethic and drive to succeed has been unleashed – and while some Western companies and industries will struggle to adapt to the heightened



competition that has resulted, the global economy will be the big winner as a result.

As a side note, not long ago South America and Eastern Europe were seen as economic and political basket cases. Now, despite the issues every nation faces in the global economic slowdown, countries like Argentina, Brazil, the Czech Republic, Poland and Hungary are poised for strong growth over the mid-term, in large measure due to the opening of economies and a renewed commitment to democratic government.

#### **10. The commitment to global trade**

When faced with tough economic periods in the past, one response was to resort to raising trade barriers – this was a key contributor to the Great Depression. The good news is that there are no signs of a global trade war – and indeed we continue to see movement towards reducing trade barriers (albeit slower than some would like).

#### **11. The continued payoff from technology**

Since the commercialization of the internet in the mid 90s, we've seen hundreds of billions of dollars invested in the technology that permeates our personal and work lives. While this technology has led to compressed margins and severe pressure on some industries (think travel agents and newspapers, for example), on balance it continues to be a huge driver of increased productivity – and with higher productivity come heightened profits. Another benefit of technology is higher return on research and development - the impact of processing power and instant communication is paying immense dividends in making research dollars more efficient, as information on new discoveries is disseminated in real time.

#### **12. A shift in focus by the best and brightest**

The best talent migrates to those fields offering the most recognition and highest pay. As a result of stratospheric compensation in the financial industry, an entire generation of the best and the brightest young people aspired to be financial engineers. Already signs point to a return to reality on compensation levels, leading to some of that same talent becoming real engineers, where their drive and abilities are going to be put to better use.

One final positive development for advisors will be more realistic expectations for investors. The good times of the past few years led some investors (and not a few advisors) to become complacent about risk. As recently as a year ago,



clients in balanced portfolios were pushing advisors to increase their equity component and investors were looking to boost the exposure to aggressive stocks in their portfolios. Just as the tech bubble taught investors to be cautious about sky high valuations, this market will leave a lasting impression on clients about the kinds of returns that can be realistically achieved without undue risk.

We continue to have real issues ahead of us and the unwinding of the excesses of the recent past will continue to be painful. When thinking about investment prospects, however, it's important to help clients understand that we are in that part of the market cycle where the problems seem overwhelming, and any positive signs are ignored. Historically, exactly these kinds of environments represent the best times to invest.

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