Third Quarter 2014 Commentary

The stock market has been reaching more new highs lately. The figure that many people seem focused on is the Dow Jones Industrial Average, which at the time of this writing is just below 17,000 and seemingly headed for 20,000 in the not-too-distant future. For the third quarter, the Dow was up 1.9%.

The Dow is composed of just 30 stocks, though, so we usually find ourselves talking about the other oft-cited broad stock market index, the S&P 500. That, too, is in record territory, closing above 2,000 for the first time ever on August 26, 2014. In the three-month period which ended September 30, the S&P advanced 1.1%.

It feels like just the other day that the S&P was in the neighborhood of 1,000, and now here we are already at 2,000. We were curious exactly how long it's been since we were at 1,000, so we took a look. It was September 3, 2009, that the S&P most recently closed above the 1,000 mark, meaning that it took almost exactly 5 years for the market to double.

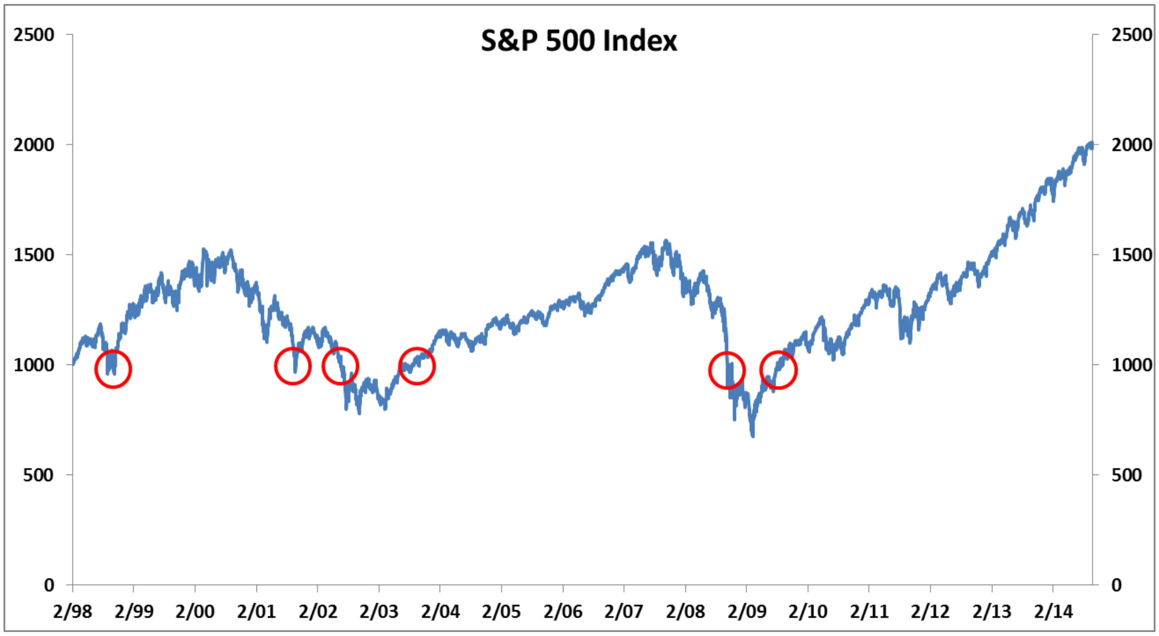
The Road Is Longer than It Looks

It seems like such a fast, wild ride, doesn't it? Just five years ago, we were at half the level we are today, and it seems like the graph has only pointed straight, up, and to the right the entire time.

An investor that bought into the market at that time and held on would have doubled his/her money in just 5 years, achieving an annualized return of about 15%. And that's excluding the healthy and growing dividends that would have been received in the meantime.

However, September 3, 2009, is not the only time the S&P 500 index has been at the 1,000 level. No, sir. It was there also in October 2008, on its way down to the bottom it touched in early 2009. It was also there in the summer of 2003, as we recovered from the depths of the Internet stock bust. It also crossed that 1,000 line a few other times before that.

But the first time the S&P 500 hit 1,000 was all the way back in February 1998. That is, an investor that bought into the stock market at that time would have had to wait nearly 17 years to see his/her investment double in value. That works out to an annualized return of only 4%, which is not that different from what we were earning on our FDIC-insured savings accounts not too many years ago.



source: Yahoo! Finance, Inkwell analysis

It Was Neither the Best of Times, Nor the Worst of Times

As crazy as those numbers above sound, the stock market can actually behave even more crazily than that. That is, the market has been known to double much more quickly than over five years, and it's also been known to double much more slowly than over seventeen years.

So while both sides of the current environment sound simultaneously awesome (earning a 15% annual return over five years) and terrible (earning just 4% over seventeen years), the market has been both more awesome and more terrible in the past.

Year	First Time for the S&P to Hit…	Minimum Years for Double	Maximum Years for Double
1954	31.25	5	27
1961	62.50	7	7
1980	125.00	6	19
1986	250.00	4	6
1995	500.00	7	9
1998	1,000.00	3	3
2014	2,000.00	5	17

source: Yahoo! Finance, Robert Shiller, Inkwell analysis

There have been three instances in the modern market era that saw a faster double than the one we have just lived through. In the Internet-fueled bull market of the late 1990s, the S&P went from 500 to 1,000 in just 3 years. In the mid-1980s, it grew from 125 to 250 in just 4 years. And in the early 1950s as America saw a great shift in manpower from the military to the workforce, the market index grew from 15.625 to 31.250 in a little under 5 years.

And while 17 years is certainly a long time to wait for a market double, there have been two longer periods—one much longer. The S&P 500 first touched 62.5 in 1961. Even with the tailwind of the "go-go" stocks of the 1960s, it did not reach 125.0 until 1980, a full 19 years later. And, of course, the record for the longest wait goes to the period of 1927-1954, a time which included the Great Crash of 1929 and the painfully lengthy Great Depression.

Are We There Yet?

"OK, Inkwell," you are probably saying at this point. "That market history is all well and good. But tell me something more useful…. how long will the next double take? Will the S&P 500 hit 4,000 in 2016? 2019? 2025? Or will I have to wait until 2041 to see that?"

Well, dear reader, we don't know. We honestly have no idea. We would certainly be surprised if it got there by 2016, but we have been surprised by the stock market before.

The only thing we can do as investors is to do our best to hang on for the ride. Trying to anticipate when the market will have a significant pullback, then trying to time a re-entry into stocks once the dust has settled, sounds like a herculean, if not impossible, task. We have yet to encounter proof that anyone has mastered that skill.

Take another look at the graph above that covers the period from 1998 to the present. Do you see all those zigs up and zags down? No one should ever expect themselves capable of correctly calling all of those moves, or even enough of them to out-perform the market by a large enough margin to make the risk worthwhile.

The important thing is that the graph slowly but surely moves up and to the right. Having a long-term time frame is essential when committing capital to the stock market, because you never know when those zigs and zags are going to occur, or how drastic they will be when they do.

Besides, every number we have presented so far has ignored one enormous input: dividends. If you include dividends in the equation, the original investment at the height of the market in early 1998 would now be worth nearly triple. And the only sure way to earn dividends on a given stock is to actually own that stock.

Our strategy is simple: invest prudently in bargain issues when we are able to find them. Theoretically, bargain issues should participate well enough in any broad market increase, and then fall less precipitously than the overall market when the correction or bear market eventually comes. And the key to long-term success in the stock market is to retain as much of your capital as possible through the depths of the inevitable bear markets, so that you can get as much of your money as possible back to work when the market starts to grow again.

We thank you again for your referrals, confidence, and support. We look forward to reporting to you again in three months.

Sincerely,

FELIPE

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