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Gleanings

Patience Required

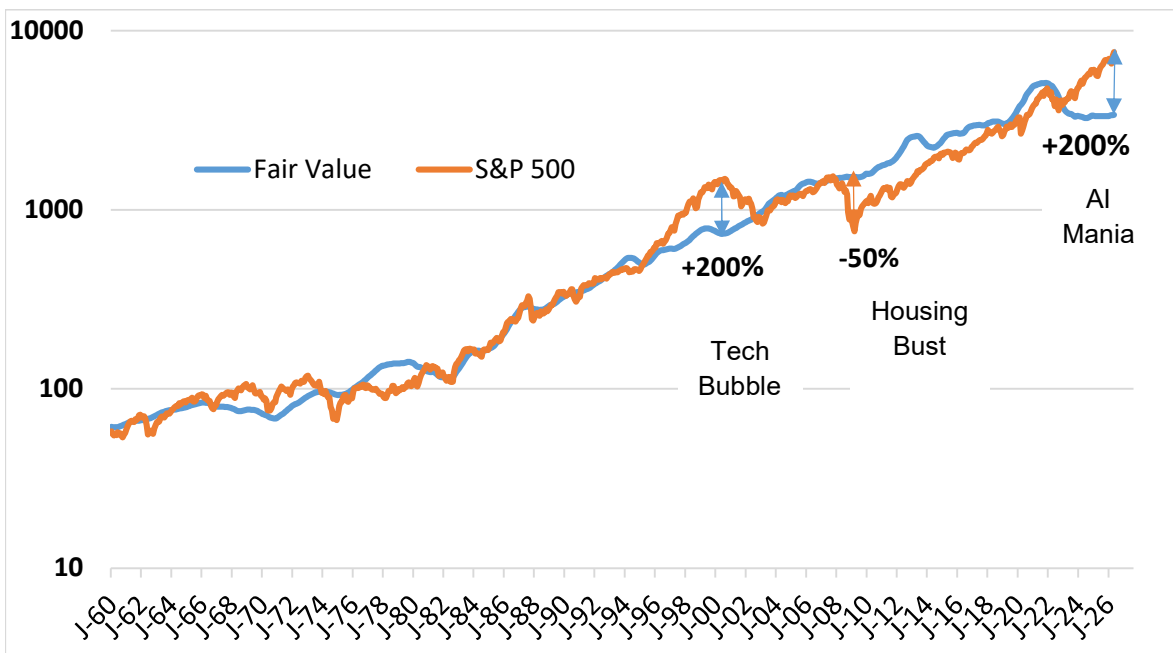
There are two ways you can handle the risk in the stock market. Both require patience.

One way is to pay attention to valuation. In the chart below, the blue line is a computation of where we would expect the S&P 500 index to be, based upon a sixty-five year history of economic growth, what one might call “Fair Value”. The gold line is where the actual price has been. You can see a pretty tight relationship between the traded price and the expected price (with the exception of a few disruptions) and that the market has indeed grown in line with the economy. Those who paid attention to valuation in 1999 (it was too high, so they sold) and 2008 (it was too low, so they bought) needed a goodly amount of patience as the greed and fear driven behavior that dominated at the time kept people buying (and selling) for months after you could see that the market price was “wrong”. Patiently selling at the top and buying at the bottom eventually yielded rewards. We see the same divergence now, with the market about double fair value.

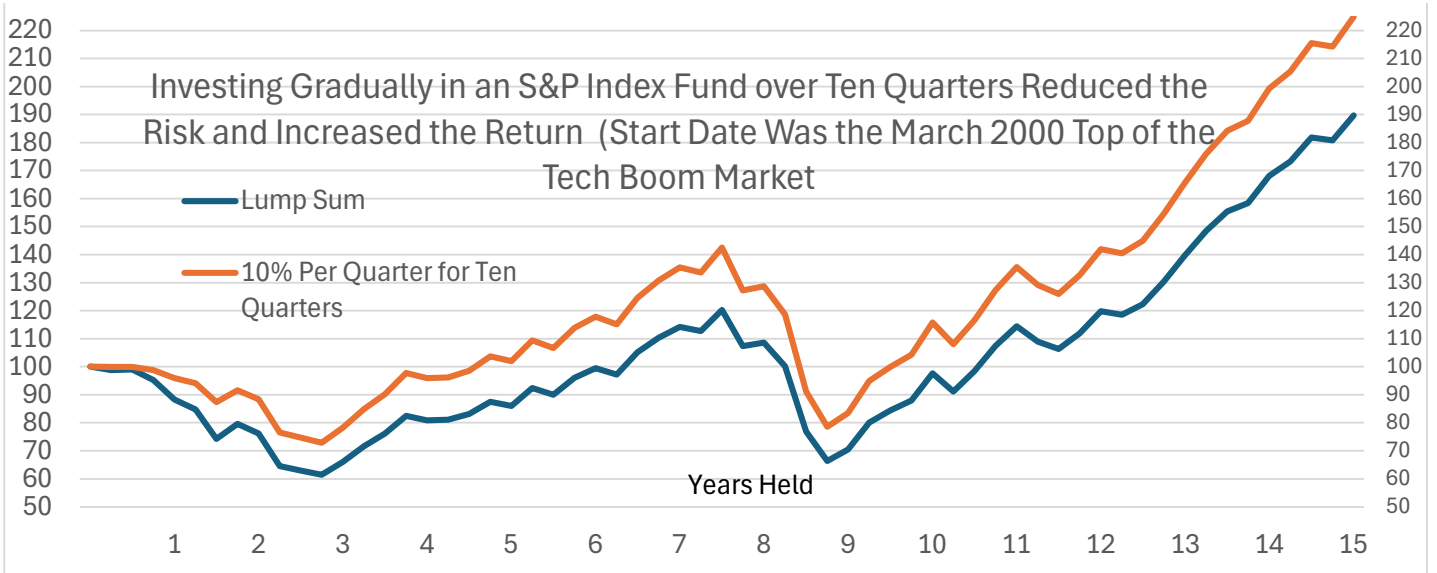
“Yes, but..” we can’t help but think. Earnings are great. Consumer spending is great. Capital spending is off the charts. What if the fair value blue line heads straight up from all the AI magic that hits over the next few years and meets the gold line somewhere in the middle. Lots of people who are smarter than I am are making that argument and some of them aren’t selling anything. That brings me to the second strategy for handling the risk of the stock market. It also requires an abundance of patience and takes advantage of the two critical elements of long-term success in the markets. Dollar cost averaging and an emphasis of investing, not trading. Those on the fence in 1999 could still buy in spite of their fears about the market’s overvaluation. They just needed to do it *slowly*. Instead of a lump sum, they could buy stocks, a little at a time, but consistently and they could avoid the sharp peaks and valleys by “averaging in”.

Index Returns

	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>YTD</u>
S&P 500	26.3	24.9	17.9	10.2%
ML 1-5 yr Gov’t/Corp	5.2	4.6	6.1	.5%
EAFE (Dev Fgn Mkts)	18.2	3.8	27.9	7.7%
Emerging Markets	10.1	7.5	30.6	22.7%



For the S&P 500, investing a little at a time over ten quarters keeps investors from buying at the absolute top and so avoids much of the downdraft seen by lump sum investors (in 2001, -27% instead of -38%). Having patience to let the economic cycles get back to normal allowed the gradual investor to see a double by year fourteen. The challenge of seeing your account drop was somewhat softened and for those who held through the decline, the 6%/yr return, while not awe-inspiring, was at least okay.



If you keep in mind that the S&P index is “cap-weighted”, that is; for example, if there are two absolutely identical companies in the index and one has a stock price that is double the other, it will have double the weight in the index. You can see the problem. We know that active managers underperform the index as they essentially are attempting to guess which stocks will be the most popular. If you’ve been reading these missives, you also know that buying a portfolio of the lowest risk, most profitable companies in the index works much better. A lump sum of \$100 invested in the eight companies that were identified in March of 2000 were worth \$189 at year three and \$816 at year fifteen. The three best: St Jude Medical, Allergan and Yum Brands each showed 10:1 returns after fifteen years. Buying and patiently holding gave 4 x’s greater return than the S&P.

If you patiently invested \$100 over ten quarters in the S&P index, the *worst* you would have done in any of the forty-six different fifteen-year periods since December of 1999 was \$146. In the low-risk stock portfolio that was held for the same length of time the worst was \$414. On average a \$100 investment in the S&P index turns into \$379 in fifteen years. On average the buy and hold portfolios become \$551. For all of those different eight stock portfolios slowly accumulated, the worst fifteen-year return was 10% per year, the best was 14% and the average was 12%. That’s a lot of predictability for buy and forget.

