L M C M
Point of View

Who's Afraid of a Sideways Market?

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Stock pickers can thrive if the market moves sideways.

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For the last twenty-five years, investors have experienced two types of stock markets—bull and bear—that either went up or down over a multi-year period. But, there is a third type of market with which many investors today are not as familiar. It is called a "sidewinder" and it produces a sideways market - one that barely changes over time.

It has been a generation since investors have experienced a prolonged sideways market (although they were not uncommon through most of the 20th century).[1] On October 1, 1975, the Dow Jones Industrial Average stood at 784. Nearly seven years later, on August 6, 1982, the Dow closed at the exact same 784. Even though nominal earnings grew over the time period, the price paid for those earnings dropped. By the end of 1975, the trailing price earnings multiple for the S&P 500 was almost 12 times. By the fall of 1982, the trailing price earnings multiple for S&P 500 earnings had declined to nearly 7 times.

Some stock market forecasters have drawn analogies to what happened in the late 1970s and what may be happening today.[2] There are concerns about the rate of corporate profit growth against the backdrop of a weak economic recovery. There are worries about contracting multiples which typically peak at the bottom of a cycle for earnings growth rates.[3] Others fear that a decline in the U.S. dollar will foster higher commodity prices, thus causing inflation to rise.

A Strategy for Sideways Markets

What's an investor to do if we are confronting a sideways market over the next several years? For those who embrace a passive index approach to investing, the results could be uninspiring. The current yield of the S&P 500 Index is 2.2%. This is a far cry from the 5% yield of the late 1970s.

Others claim we are now in a "traders' market." They argue that in a sideways market, the "buy and hold" strategy is dead, and the only way to make money is to trade stocks rapidly. I have little to say about this approach other than to point out that it is quite difficult for the overwhelming majority of investors. The idea of buying a stock that is quickly going up and then selling it before it rolls over is intellectually appealing but incredibly difficult to employ successfully. If you are contemplating a trading strategy, take a breath and truthfully admit to yourself that only a very small percentage of people are able to do it profitably.

Long-term investors may think their only hope for a decent total return is to invest in high dividend yielding stocks.[4] While dividend yield does comprise a significant part of a stock's total return, it is not the only source of total return one could expect in a sideways market. Indeed, despite a stock market that is largely spinning its wheels, there is ample opportunity to earn excess returns from buying and holding value creating businesses over a three- to five- year period of time.

We believe there is ample opportunity to earn excess returns in a sideways market from buying and holding value creating businesses over a three- to five-year period.

We decided to study the behavior of the 1975 to 1982 sideways markets after recalling the exceptional investment performance generated over these years by Warren Buffett at Berkshire Hathaway and Bill Ruane at the famous Sequoia Fund.[5] Over this period, Berkshire Hathaway and the Sequoia fund generated cumulative total returns of 676% and 415%, respectively, and average annual returns of 34% and 28%, respectively.[6] Remember, these were not traders. Both Buffett and Ruane bought and held, over a multi-year period of time, outstanding companies.

Our Research Team examined the return performance of the 500 largest stocks in the market between 1975 and 1982.[7] What we discovered surprised us.

Taking the 500 largest stocks at the beginning of each year (1975-1982) we found that, on average, 3% of this large cap basket of stocks went up in price by at least 100% over the course of the following year. Put differently, on average, only 16 out of 500 stocks doubled in any one year. Even for the best stock pickers, it would have been a significant challenge to consistently identify these stocks in advance each year.

When we extended the holding period to three years, the results were more encouraging. Over rolling three-year periods, on average, 18.6% of the stocks doubled; 93 out of 500.

When we extended the holding period to five years, the results were eye popping. On average, an astonishing 38% of the stocks went up 100% or more; that's 190 out of 500.

Number of Doubles or Greater Over Rolling One-Year Periods (Top 500 Companies)

Range	1975	1976	1977	1978	1979	1980	1981	1982	**Total**
# of Companies	46	5	0	2	27	34	2	8	**124**
% of 500	9.2%	1.0%	0.0%	0.4%	5.4%	6.8%	0.4%	1.6%	**3.1%**

Number of Doubles or Greater Over Rolling Three-Year Periods (Top 500 Companies)

Range	1975-77	1976-78	1977-79	1978-80	1979-81	1980-82	**Total**
# of Companies	148	36	48	132	101	93	**558**
% of 500	29.6%	7.2%	9.6%	26.4%	20.2%	18.6%	**18.6%**

Number of Doubles or Greater Over Rolling Five-Year Periods (Top 500 Companies)

Range	1975-79	1976-80	1977-81	1978-82	**Total**
# of Companies	268	186	112	193	**759**
% of 500	53.6%	37.2%	22.4%	38.6%	**38.0%**

The obvious question is, how can 38% of the stocks in an index go up 100% or more over a time period when the index itself barely moved? The answer is revealed not by a finance professor, but by one of the most influential evolutionary biologists of our generation – Stephen Jay Gould.

The Spread of Excellence

In his highly acclaimed book, *Full House: The Spread of Excellence From Plato to Darwin*, Gould talked about the importance of distinguishing between the trends of a system and the trends in the system. "The old Platonic strategy of abstracting the full house as a single figure (an average)…and then tracing the pathway of this single figure through time, usually leads to error and confusion."[8] Because people have a "strong desire to identify trends," it often leads them "to detect a directionality that doesn't exist."[9]

> During the sideways market of 1975 to 1982, an average of 38% of the 500 largest stocks in the market appreciated over 100% during each five-year rolling period.

Putting it in Gould's terms, investors who observed the stock market between 1975 and 1982 and focused on the "full house" (the market average) came to the wrong conclusion. They wrongly assumed that the direction of the market was sideways, when in fact the variation within the market was dramatic and led to plenty of opportunities to earn high excess returns.

Gould tells us that by studying the variations in a system, we will be able to better observe changing patterns over time. These changing patterns, he explains, are thought to be trends to improvement, or what he refers to as the "spread of excellence."

Applying this idea to the stock market, we see that what we first thought to be a trendless sideways market was in fact a market full of variation. That quickly brings us to the next two questions: where did the trends of improvement occur and who made the list?

The following tables list the ten sectors of the S&P 500 Index, the number of companies within each sector and the percentage of companies that outperformed over each five-year rolling period.

Between 1975 and 1982, the greatest number of companies in the S&P 500 were located in the following five sectors: industrials, materials, utilities, financials, and consumer discretionary. Interestingly, the energy, health care, information technology and telecommunication services sectors contained the least number of companies.

When we calculated which sectors had the highest percentage of companies that went up in price by at least 100% over the time period, the line-up changed. Analyzing the five-year rolling average, we see that energy was the top sector with the highest percentage number of outperformers (67.8%), followed by industrials (42.7%) and information technology (42.6%). At the bottom of the list were telecommunication services (30.6%), utilities (28.4%), and consumer staples (23.5%). Despite the fact that energy and information technology were among the sectors with the fewest total names in the S&P 500 Index during the period, they had between them the highest percentage of outperformers in the rolling five-year periods. We might say Stephen Jay Gould's "spread of excellence" flowed through these two sectors.

In the Appendix, we list the ten sectors of the S&P 500 Index and note several companies in each sector that at least doubled over a five-year rolling period between 1975 and 1982. Many companies went up substantially more than 100%.

The years between 1975 and 1982 were unsettling. Regional wars in Southeast Asia and the Middle East had become commonplace. The repercussions of the failed Nixon administration continued to ripple through our political system. In those seven years, Americans were led by three different presidents: Ford, Carter and Reagan. Unrelenting double-digit annual increases in oil prices caused economic dislocation, which in turned caused inflation to soar, forcing banks to raise their lending rates. By 1980, inflation was growing by over 13%. That same year, the prime rate hit 21%.

It is easy to analyze the list of companies and quickly dismiss high performers as nothing more than companies that benefited from the rise in oil prices and inflation. Energy companies are strongly in the above average list; so are the materials and utilities companies, which included mostly natural gas distributors. The companies in the consumer discretionary, consumer staples, and health care sectors were superior performers because of their ability to raise prices to match or even exceed inflation.

Table 1: Industry Analysis Based on Rolling Five-Year Periods		
Sector	# of Companies[A]	% of Total Companies[B]
Industrials	**307**	**15.4%**
Materials	303	15.2%
Utilities	278	13.9%
Financials	**259**	**13.0%**
Consumer Discretionary	253	12.7%
Consumer Staples	217	10.9%
Energy	**199**	**10.0%**
Health Care	87	4.4%
Information Technology	**61**	**3.1%**
Telecommunication Services	36	1.8%
Total	2000	100.0%

Table 2: Industry Analysis Based on Rolling Five-Year Periods		
Sector	# of Companies Doubling[C]	% of Companies Outperforming[D]
Energy	**135**	**67.8%**
Industrials	**131**	**42.7%**
Information Technology	**26**	**42.6%**
Financials	**109**	**42.1%**
Consumer Discretionary	253	36.8%
Health Care	217	34.5%
Materials	199	31.0%
Telecommunication Services	87	30.6%
Utilities	61	28.4%
Consumer Staples	36	23.5%
Total	759	38.0% (Wtd Avg)

[A]Total number of companies over the six five-year rolling periods between 1975 and 1982.
[B]The percentage of the total from the given sector.
[C]The number of companies within a given sector that doubled or greater within the rolling periods examined.
[D]The number of stocks that doubled or greater divided by the total number of companies in the sector over the time periods examined.

But to see this sideways market as nothing more than a game of how to beat inflation strikes me as an oversimplification. We decided to dig deeper into the results to see if we could discover any additional anomalies that might help us understand more about the market's behavior.

We asked our friends at Empirical Research Partners to examine the largest stocks in the stock market between 1975 and 1982.[10] Empirical employs quantitative research and has data on stocks reaching back to 1952. They analyze individual stocks and markets within four distinct buckets.

Valuation
Capital Deployment and Financing
Earnings Quality (growth)
Market Reaction (momentum)

According to Empirical Research, the Valuation-based strategy performed best during this period. Not only was it the best among the four, it outperformed its historical average return by 60%. The second best performing strategy was Earnings Quality (growth), which outperformed its historical average by nearly as much as the Valuation based strategy. The Market Reaction (momentum) strategy performed worst.

This makes sense. Momentum strategies work best once the direction of the market has been established. Momentum strategies also are closely aligned with investor sentiment. In sideways markets, sentiment sloshes back and forth largely because the trajectory of the economic recovery is unknown. At times, the data may indicate the economic recovery is gaining strength leading to a short blast in stock prices, only to be followed by weak economic readings which causes sell-offs. In this environment, momentum investors find themselves constantly whiplashed.

Examining the results from Empirical Research, we find the optimal stock picking strategy between 1975 and 1982 was to select undervalued growth companies. Today, we sometimes hear a call for investors to now consider an active approach to

stock selection. The call is distant and very faint. This timidity is understandable. First, common stocks have, for only the second time since the Great Depression, produced a negative total return for the trailing decade. Ten-year US Treasuries, on the other hand, have generated a positive 6.7% average annual return over the same period. Not surprisingly, investors currently favor fixed-income securities over stocks. Secondly, active strategies, over the past several years, have struggled to cover themselves in glory; they largely underperform passive strategies. But, it is often at the point of maximum pessimism when investors can find opportunities to earn high excess returns.

A recent Goldman Sachs research report identifies several reasons why investors should now choose active common stock strategies over passive strategies.[11]

1. As stock market volatility has continued to decline towards its long-term average, correlations between stocks have declined. This means company-specific fundamentals are more of a determinant of future stock prices.
2. The prospects for multiple expansion appear limited. As mentioned earlier, it is unlikely we will experience a substantial increase in the market multiple from here. When market multiples rise, it has a tendency to lift all boats. But without a broad based increase in the market multiple, stock selection becomes ever more so important.
3. In a below-average economic recovery there will be market share gainers and losers. In a sub par growth environment, growth becomes the scarce resource. The scarce resource is often bid higher. Companies driven by long-term secular growth trends will be more valuable than those companies whose fortunes are closely tied to a leveraged economy.

Based on Empirical Research's study, we found the optimal stock picking strategy between 1975 and 1982 was to select undervalued growth companies.

Conclusion

So …who should be afraid of a sideways market? Although it is not certain we will experience a sideways market over the next several years, if we do (and I want to underscore "if") momentum investors will likely struggle. With no long-term trend in place, it will be tough for a momentum strategy to produce sustainable profits. Second on the list would be index investors. If the price of the index is little changed in the coming years, then the most index investors can hope for is a paltry 2% annual dividend yield.

Who should not be afraid of sideways markets? Stock pickers! Whether the approach is to select stocks that pay higher dividends or companies that are growing shareholder value at an above-average rate, I believe the game is now in the hands of those investors who can identify mispriced stocks.

Warren Buffett differentiates between the "know-something" investor and the "know-nothing" investor. If you are a "know-*nothing*" investor – that is you do not have the skill set to identify which stocks are undervalued - then you should favor a broadly diversified portfolio approach – something akin to index investing. "On the other hand," says Buffett, "if you are a know-*something* investor, able to understand business economics and…find…companies that possess important long-term competitive advantages, conventional diversification (index investing) makes no sense for you. It is apt simply to hurt your results."[12]

Whether we are in for a sideways market for the next several years is open for discussion. However, the central point of this research is to remind investors, despite the average returns of a broad index, there are significant opportunities and profits to be made by those who understand the variations within the system. No matter how the stock market behaves, or how the underlying economy performs, there will be, in the words of Stephen Jay Gould, a "spread of excellence." In financial ecology, there are always changing patterns and trends to improvement. As such, the investment landscape favors the stock picker – perhaps now more than ever.

About the Author

Robert Hagstrom currently serves as Portfolio Manager of the Legg Mason Capital Management Growth Trust mutual fund and manages the Growth Equity strategy for institutional investors. Robert earned a B.A. and M.A. from Villanova University. Robert received the CFA designation in 1992 and is a member of The CFA Institute and the CFA Society of Philadelphia. Robert is also known for his best-selling book, *The Warren Buffett Way: Investment Strategies of the World's Greatest Investor*. He has also written a number of investment books including: *The NASCAR Way: The Business That Drives the Sport; The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy; The Essential Buffett: Timeless Principles For a New Economy; Investing: The Last Liberal Art; and his latest book The Detective and The Investor: Uncovering Investment Techniques from the Legendary Sleuths.*

Footnotes

1. There were a variety of sideways markets during the 1900s that preceded the sideways market of October 1975 to August 1982. On June 30, 1933, the Dow Jones Industrial Average (Dow) stood at 98.14. Nine years later, on May 26, 1942, the Dow closed at 99.41. From March 6, 1945, until June 13,1949, the market went sideways, starting at 161.5 and ending at 161.6. Over the next nine years, from January 13, 1950, until December 31, 1958, the Dow jumped 197% in price before settling into a four year slump (567 on November 17, 1958, and closing at 568 on October 22,1962). Then, off again we went with a roughly 70% gallop straight up over the next three years, 1963-1965, only to be followed by a four-year mind-numbing sideways market grind into 1970. Between October 10, 1966, and February 4, 1970, the Dow went from 754.5 to 754.5.
2. "The Late-'70s is Setting Historical Basis for Comparison," Strategas Research Partners, Sector Strategy Report, June 8, 2009.
3. In February 2009, the trailing price-earnings multiple of the S&P 500 Index was 10.4x. Currently it stands at 25x trailing earnings. It is difficult to imagine market multiples can rise from here. The stock market's next phase will likely focus on the rate of corporate earnings growth to back fill the already expanded multiples. If the growth of earnings is sluggish, multiples may contract. For further discussion see "Equity Portfolio Strategy Insight: The Return of Fundamentals and the Multiple Contraction Playbook," Adam Parker, Bernstein Research, September 29, 2009.
4. Bill Gross recently recommended this strategy in his latest *Investment Outlook* (December 2009).
5. Robert G. Hagstrom, **The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy**, (John Wiley & Sons, 1999).
6. Returns are average annual calendar-year returns for 1975-1982.
7. I wish to acknowledge the Legg Mason Capital Management Research Department including the work of Randy Befumo, Director of Research, Arturo Rodriquez, Security Analyst, Peter Shapiro, Research Analyst, and Graham Savage, Associate Analyst.
8. Stephen Jay Gould, **Full House: The Spread of Excellence from Plato to Darwin**, (Three Rivers Press; New York; 2006), p. 217.
9. Gould, p. 41.
10. I wish to thank Empirical Research Partners, Michael Goldstein, Brian Cho, Nicole Price and Norman Sanyour for their dedicated research help.
11. "Top 5 Reasons to Choose Active over Passive Now," Goldman Sachs Asset Management, Fundamental Equity Market Insights, March 2009.
12. Berkshire Hathaway 1993 Annual Report.

Appendix

Energy

Energy	
Southland Royalty Co	+1407%
Texas Oil & Gas	+1277%
Mesa Petroleum	+1028%
Amerada Hess	+ 555%
Superior Oil	+ 529%
Shell Oil Co	+ 500%
Murphy Oil Corp	+ 490%
Schlumberger	+ 453%
Pennzoil Company	+ 406%
Sun Oil Co	+ 363%
Mobil Oil	+ 361%
Halliburton Company	+ 278%
Dresser Industries	+ 276%
Baker International	+ 260%
Gulf Oil Corp	+ 184%

Industrials

Industrials	
Teledyne Inc	+1605%
Boeing	+1445%
General Dynamics	+ 713%
Signal Dynamics	+ 607%
Raytheon Co	+ 504%
Martin Marietta Corp	+ 490%
Fluor Corp	+ 460%
Cooper Industries	+ 433%
Rockwell International Corp	+ 427%
McDonnell Douglas Corp	+ 397%
Burlington Northern	+ 382%
Union Pacific Corp	+ 382%
Honeywell Inc	+ 367%
Litton Industries	+ 346%
Northrop Corp	+ 302%

Information Technology

Information Technology	
Tektronix Inc	+ 545%
Control Data Corp	+ 424%
NCR Corp	+ 415%
Hewlett Packard Co	+ 311%
Digital Equipment	+ 307%
Perkin Elmer Corp	+ 269%
Intel Corp	+ 217%
Harris Corp	+ 209%
Automatic Data Processing	+ 179%
Motorola Inc	+ 169%
Digital Equipment	+ 115%
Sperry Rand Corp	+ 108%
Texas Instruments	+ 103%

Financials

Financials	
American General Ins Co	+ 421%
Marriott Corp	+ 420%
Merrill Lynch & Co	+ 396%
Loews Corp	+ 392%
Crum & Foster	+ 341%
Transamerica	+ 293%
Genstar Ltd	+ 293%
Western Bancorporation	+ 291%
Combined Insurance Co Amer	+ 289%
Unites States Fid & Gty Co	+ 237%
Security Pacific	+ 225%
General Reinsurance Corp	+ 231%
MGIC Investment Corp	+ 226%

Consumer Discretionary	
Tandy Corp	+1060%
Warner Communications	+ 778%
MCA Inc	+ 479%
Macy RH & Co	+ 450%
American Broadcasting Cos	+ 419%
Levi Strauss	+ 408%
McGraw Hill Inc	+ 382%
Time Inc	+ 355%
Dow Jones & Co	+ 354%
Capital Cities Communications	+ 340%
Hilton Hotels	+ 321%
Times Mirror Co	+ 313%
Dana Corp	+ 304%
Knight Ridder Newspapers	+ 303%
Dun & Bradstreet Cos	+ 287%

Health Care	
Hospital Corp America	+ 557%
SmithKline Corp	+ 531%
Syntex Corp	+ 444%
Searle GD & Co	+ 272%
Abbott Laboratories	+ 263%
International Minerals & Chem	+ 255%
Pfizer Inc	+ 199%
Medtronic Inc	+ 191%
Baxter Travenol Labs Inc	+ 170%
American Hospital Supply Corp	+ 157%
Bristol Myers Co	+ 138%
Rorer Archem Inc	+ 130%
Squibb Corp	+ 122%
Johnson & Johnson	+ 119%
American Cyanamid	+ 118%

Materials	
Freeport Minerals Co	+ 712%
NL Industries Inc	+ 651%
Pacific Lumber	+ 338%
Alcan Aluminum Ltd	+ 324%
Asarco Inc	+ 304%
Placer Development	+ 304%
Dart Industries	+ 297%
Newmont Mining	+ 291%
Boise Cascade Corp	+ 287%
Kaiser Aluminum & Chemical Corp	+ 285%
Mead Corp	+ 278%
Dome Mines Ltd	+ 276%
Fort Howard Paper Co	+ 264%
Koppers Co	+ 261%
American Smlt & Refing Co	+ 244%

Telecommunication Services	
Southern New England Tel Co	+ 163%
Communications Satellite Corp	+ 154%
General Tel & Electrs Corp	+ 146%
Continental Telephone Corp	+ 133%
United Telecommunications	+ 124%
New England Tel & Teleg Co	+ 117%
Pacific Northwest Bell Tel	+ 114%
Central Tel & Utils Corp	+ 111%

Utilities	
Consolidated Edison Co NY	+ 419%
Enserch Corp	+ 330%
Arkansas La Gas Co	+ 322%
Pioneer Corp Tx	+ 312%
Panhandle Eastern Pipe Line	+ 311%
Brascan Ltd	+ 286%
Texas Gas Transmission Corp	+ 273%
Texas Eastern Transmission Corp	+ 253%
Southern Nat Res Inc	+ 243%
Northern Nat Gas Co	+ 237%
Consolidated Natural Gas	+ 228%
El Paso Co	+ 224%
Consumer Power Co	+ 219%
Houston Natural Gas Corp	+ 217%
Florida Power Corp	+ 215%

Consumer Staples	
Kroger Company	+ 290%
Esmark Inc	+ 285%
Anheuser Busch Co	+ 281%
American Brands	+ 220%
Archer Daniels Midland Co	+ 213%
Consolidated Foods Corp	+ 195%
Pioneer Hi Bred Intl Inc	+ 190%
Heinz HJ Co	+ 188%
Lucky Stores	+ 183%
Quaker Oats Co	+ 171%
Nabisco Inc	+ 166%
Chesebrough Ponds Inc	+ 153%
Gillette Co	+ 152%
Clorox Co	+ 147%
General Foods Corp	+ 145%

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