LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"What we anticipate seldom occurs, what we least expect generally happens."
—Benjamin Disraeli, 1837

As we enter the last year of the decade of the 1980's, we find ourselves in an arena far different from that of one year ago. Last year at this time, the October 1987 stock market crash was fresh in everyone's memory. A popular view was that at the very least the crash was an omen of recession with something more severe a real possibility. Economists were almost unanimous in predicting a mass retreat of the consumer with a crippling effect on the economy. As it turned out, the economy was surprisingly healthy in 1988, seemingly disregarding formidable and persistent economic problems. Benjamin Disraeli's observation of some one hundred fifty years ago proved to be especially appropriate for this past year.

The strength of the economy led to a good year in the stock market. With a total return (dividends plus appreciation) of 16.6% the Standard & Poor's 500 rose for a record setting seventh year in a row. This brings the ten-year annual return on stocks to 16.3%–one of the best decade-long returns in history. The sobering aspect of this development is that the stock market has historically returned about 10% on average with extended periods of higher return (such as the average of the past ten years) followed by periods of lower return.

The generous equity returns of recent years can be associated with the extended economic expansion. The United States is now in its seventh consecutive year of economic growth. That is a peacetime record–exceeded only by the expansions of 1938-45 and 1961-69 which had as underpinnings WW II and the Vietnam conflict, respectively. However, the business cycle is an enduring fact of life, and the upward phase of the present cycle will end–we just do not know the timing or the severity of the eventual downturn.

To a certain extend, an eventual economic decline is already discounted by the stock market. Investor psychology is extremely negative as exemplified by high cash levels, low equity position as a percent of financial assets, and general apathy toward the stock market. The question which is unanswered is whether the discounting is sufficient to compensate investors for the risks associated with an economic decline not to mention the attractive returns offered by the bond market.

How does the investor cope with a market which has provided above-average returns for some time, and yet, at least to a certain extent, already reflects the concerns associated with an aging economic expansion? For one thing, given our skepticism about anyone's ability to read the future, we think it is imprudent to take an extreme position based on an economic forecast. Therefore, we continue to advocate a balanced approach with respect to investment portfolios. Bonds still seem attractive to us, and any additional rise in interest rates would only make them more so. As a class, stocks do not appear exceptionally attractive. However, there are individual issues which appear reasonably priced. Careful selection and diversification are critical ingredients to success. Finally, it appears prudent to maintain a reserve for equity purchases. Opportunities will become available in the form of new ideas and probably lower prices. Over time a balanced and diversified approach has worked well. We believe that such an approach will continue to be effective.

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450 Regency Parkway, Suite 410 | Omaha, Nebraska 68114-3701 | *tel* 402.392.2606 | *fax* 402.392.2597 | www.lawsonkroeker.com