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# PREDICTABLES AND UNPREDICTABLES

*This is an update of a Letter we last published almost a decade ago. Given recent events, we thought it an excellent time to revisit these timeless principles for successful investing over the long haul.*

One of the biggest failings in our society is a widespread tendency to focus undue emphasis on the short run. Far too often, politicians, business executives and other leaders make important decisions largely on the basis of what they think will "look good" over a short period of time.

This is especially true in the stock market, which in one way or another mirrors the national mood. At times, the majority of investors seem to believe that the whole future is wrapped up in the headlines of the day or in predictions of tomorrow's economic and financial events.

More frequently than not, however, the immediate future does not turn out the way people think it will. Last winter, for example, the vast majority of observers on Wall Street were extremely pessimistic about the economy and the stock market. As it turned out, they were wrong on both counts.

There is one basic reason why the consensus expectation is often so wide of the mark. Some factors in the outlook simply cannot be accurately or consistently predicted by anyone, no matter how informed he or she might be. Four major unpredictables that are always in the picture are:

***The Unpredictables***

1. ***What stock prices or interest rates will do next week, next month or next year.***
2. ***Which way the political winds will blow or government policies change.***
3. ***How fast or slow the GDP will rise in each of the next few quarters.***
4. ***Where or when the next big international crisis will occur.***

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For as long as we can remember, the great bulk of the general investment literature has been devoted to these always intriguing, but unanswerable, questions. Yet practically none of this material is ever of any help in formulating investment policy or making specific decisions.

In contrast, there are some important longer-range trends that can be predicted with a fair degree of certainty. Following is a list drawn up nearly 50 years ago by the late David L. Babson, an investment counselor who originated the philosophy of long-term investing in growth companies. The list is still valid today:

***The Predictables***

1. ***The population, including those of working age, will continue to grow.***
2. ***More people will need more goods and more services.***
3. ***Research will develop new products and new techniques, and in the process create higher demand, additional jobs and greater productivity.***
4. ***The dollar's buying power will keep on shrinking.***
5. ***Well-managed companies with favorable long-term investment characteristics will continue, as a group, to provide their shareholders with above-average progress in earnings and dividends.***

These predictables seldom receive any attention in the financial pages. But over a reasonable period of time, they exert an infinitely greater impact on investment results than the perennially limelighted unpredictables.

Who remembers now whether anyone called the market turn of 1987 or was right about interest rates in 1994? And looking back, how much did it really matter? The crucial task facing long-term investors has been, is, and will continue to be how successfully they are able to benefit from the effects of economic growth and, at the same time, protect their capital against the persistent erosion caused by inflation.

Population growth, our first predictable, occurs so steadily that its importance to the economy is vastly underrated. From 1959 to 1999, the world population increased from 3 billion to 6 billion, a doubling that occurred over 40 years. The latest projections from the Census Bureau imply that population growth will continue into the 21st century, although at a slower rate. The world population is projected to grow from 6 billion in 1999 to 9 billion by 2045, an increase of 50% over 46 years.

In the U.S., current estimates indicate the population has grown almost 10% since the 2000 census. While the population officially reached the 300 million mark in 2006, it will likely reach 400 million in 2043. And these figures do not include illegal immigrants residing within our borders.

With the financial crisis and the recession, demand for goods and services has slowed in recent years. Over the long-term, the economy's growth has been fairly consistent -- doubling within a narrow time span ranging from 21 to 24 years. In the latest period however, the time span has lengthened to an estimated 30 years:

**Long-Term Growth of U.S. Economy**

Real Gross Domestic Product Doubled Between

| | |
|---|---|
| 1986-2009E | — *increasing at an average of 2.3% per year, should double in 30 years* |
| 1963-1986 | — 23 years |
| 1942-1963 | — 21 years |
| 1918-1942 | — 24 years |
| 1897-1918 | — 21 years |
| Average | — 22 years |

It's important to keep in mind that the economy achieved these doublings despite the repeated impact of recessions, depressions and wars. While growth has slowed recently, it is entirely possible that, within another generation, the level of economic activity in the U.S. will double again in size. Aside from population growth, enormous new markets exist overseas and as they develop, they are likely to become increasingly important to U.S.-based businesses.

Research and development, our third predictable, also should be viewed from a long-term perspective. Since 2000, R&D spending has been a fairly consistent portion of Gross Domestic Production:

**Research & Development Spending**

| | ($Bil.) | % GDP | | ($Bil.) | % GDP |
|---|---|---|---|---|---|
| 2007 | 368.1 | 2.7% | 2000 | 267.6 | 2.7% |
| 2006 | 347.9 | 2.6 | 1990 | 152.0 | 2.6 |
| 2005 | 323.0 | 2.6 | 1980 | 63.2 | 2.3 |
| 2004 | 299.9 | 2.6 | 1970 | 26.3 | 2.5 |

*Source: National Science Foundation.*

While it is likely that overall spending on research and development activities slowed during the financial crisis, there is no reason to believe that such a dip will become permanent. Despite the talk on Wall Street, the advances in information technology continue to enable scientists, engineers and others in many industries to speed up the experimental process and to significantly shorten the lead time between conceptual innovation and full-scale commercialization.

As a result, a stepped-up flow of new products and techniques has been seen across most industries. Also, productivity has improved dramatically, which with population growth comprises the foundation of long-term economic growth.

Our fourth predictable, the dollar's buying power, increased in 2009 for the first time since 1955. However, as the table below shows, today's dollar is worth only a little more than a 1939 nickel:

**The Vanishing American Dollar, 1939 = 100 Cents**

| | | | |
|---|---|---|---|
| 2009 — 5.4¢ | 1995 — 7.6¢ | 1980 — 14.6¢ | 1965 — 41.4¢ |
| 2005 — 5.9 | 1990 — 9.0 | 1975 — 23.4 | 1960 — 44.1 |
| 2000 — 6.7 | 1985 — 11.0 | 1970 — 33.3 | 1955 — 48.8 |

How much inflation did it take to do such a number on the once mighty dollar? The answer: an average rate of about 4% a year! For anyone concerned about the long-term, there is a lot of food for investment thought in the trend depicted above.

But even so, the total investment return from common stocks has more than kept up with inflation over the years. The table below shows the average annual return from capital appreciation and dividend income combined in each of the four periods since 1897 during which the economy has doubled:

| **Periods of Doubling** | **Avg. Annual Increase** | | **Avg. Annual Return** |
|---|---|---|---|
| **(Real GDP)** | **Real GDP** | **Consumer Prices** | **Common Stocks** |
| 1963-1986 | 3.2% | 5.7% | 10.0% |
| 1942-1963 | 3.5 | 3.0 | 15.1 |
| 1918-1942 | 3.2 | 0.3 | 5.9 |
| 1897-1918 | 3.3 | 2.9 | 7.4 |
| **Recent Trend** | | | |
| 1986-2009 | 2.3% | 3.0% | 9.3% |
| **Long-Term Average** | | | |
| 1897-2009 | 3.2% | 3.0% | 9.4% |

Note that the total investment return from common stocks has averaged over 9% per year for the long-term period through 2009. Even for the most recent period, the total return from common stocks has far exceeded the pace of inflation. And real return (total return less inflation) has averaged just over 6% -- or more than twice the growth of real GDP, despite the so-called "lost decade" of the last ten years. In fact, in all five periods since 1897 the real return on stocks has far exceeded both the pace of inflation and real economic growth.

And these results are just for the average company. As our previous Letters have shown, high-quality companies in general have turned in results far superior to the merely average company. With their top-notch management teams, solid fundamental characteristics and expanding markets, these companies tend to weather financial and economic storms.

In sum, the record clearly shows that the shares of leading companies are an effective investment tool for combating inflation and for participating in the economy's growth over the long haul. It is the predictables that matter, not the headline-grabbing, mesmerizing, ever-changing unpredictables.