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## Our Reflection in a Window

This third straight year of stock market decline, a string not seen since World War II, has resulted in the condemnation of certain corporate executives and Wall Street firms for their behavior in the past decade. Some of the accused knowingly committed fraud, while others were just lemmings going along with the crowd. Both groups should be punished, if guilty, the former more severely than the latter. Before investors become too self righteous, however, they should consider how we got here.

The stock market consists of three players: Companies with publicly traded stocks; investors; and Wall Street. Companies want liquid financial markets in which they can raise capital. Investors want ownership of businesses that grow their money. Wall Street (including investment banks, brokerages and investment managers) wants to assist both parties. All three players have an incentive to maintain the integrity of the financial markets, something that is built over time.

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Traditionally, investment virtue has been measured by time frame, with long term investors championed over the “gambling” of short term speculators. In the stock market bubble, though, there was a shift in focus from the long term to the short term. Corporate executives, compensated with stock option grants, started managing earnings to keep the stock up. To gain corporate clients, Wall Street firms perverted their research departments into the lap dogs of investment banking, trading long term integrity for short term gain.

The three players in the financial markets, however, represent a system of checks and balances. The shift to a short term focus by corporations and Wall Street would not have been possible without the acquiescence of investors. The best deceptions are those that enlist the knowing and somewhat guilty support of the victim. After a long bull market stretching back to the early 1980’s, investors seemed willing to abandon the long term virtues of value and compounding for the lure of short term gain and speculation. Day traders became heroes. Pension plan choices were made on the basis of recent investment performance. The stock market was a genie, granting everyone’s wishes for an early, lavish retirement.

You hear about obvious swindles and your reaction is “how could the victim be so stupid?” The reason is that the victim wanted the promise to be true but subconsciously knew it would disappear if analyzed. The lure of easy money made investors willing participants in a mass delusion that worked as long as nobody paid close attention. The recent bubble seemed to overthrow all traditional notions of business valuation and caution in favor of a short term

orientation – what’s “hot,” who “made the number” in quarterly earnings releases and which stocks had momentum. Trend was all that mattered, and absolute levels of market pricing relative to business fundamentals became irrelevant.

The boom gave investors an excuse to ignore the dry aspects of accounting and security analysis. Now investors are shocked that the books (that they were ignoring anyway) were cooked. Companies were rewarded with a rising stock price for adopting the most liberal accounting methods imaginable. Normally sober people, who would chuckle at the cupidity of the Dutch bidding up tulip bulbs in the 1600s, ran out and bought Internet companies with fantasy business plans. Investment firms were rewarded for only telling good news while analysts who questioned the bubble were fired or silenced. The moderator of *Wall Street Week* disgraced and fired long time panelists for the sin of being cautious. Many in the financial media helped accelerate the insanity, as did politicians and regulators unwilling to intervene while everyone was enjoying the unsustainable boom. Investment advisers stopped advising and started enabling the destructive behavior of their clients. Investors became haunted by the notion that “everyone is getting rich except me.” In an irrational world, rationality was not rewarded.

***“We live in an investment world populated not by those who must be logically persuaded to believe, but by the hopeful, credulous and greedy, grasping for an excuse to believe.”***  
***-- Warren Buffett on the stock market bubble of the 1960s.***

None of this excuses those who engaged in illegal or unethical behavior. They should be quickly and severely punished to provide an example to others, among other reasons. As we drive the cart filled with evil doers towards the guillotine, however, let us pause to catch our reflection in a window. If the markets are dead, we were all complicit in the killing.

An “investor” who bought stock in a company selling at 250 times sales should not now complain that some analyst made him or her do it. There is no point in those engaged in slipshod behavior being enraged at others for being careless. All three market players had to cooperate to create the bubble.

Despite our caution during the boom, we are not happy with the comeuppance of the lemmings -- a ruined stock market means our professional environment is damaged as well. Having to wait until a new generation comes of age that isn’t haunted by the memory of the recent bear market is not very palatable. Our hope for the New Year is that the irrationality of the boom and bust of the past several years has come to an end, and that we are once again in a period in which true analysis has value and rational, clear-headed behavior is rewarded. Our job has been to shepherd our clients through this difficult, fast-buck era and have them survive to enjoy the more mundane, but ultimately more satisfying, rewards of normal financial markets.

*Buffett quote from “Supermoney” by Adam Smith, Random House, 1972.*