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The Price of Tuna Fish Just Doubled. Let's Go to the Store!

An unfortunate fact about investing is that it is done by humans. The human brain is not wired to make naturally good investors. Let's illustrate this by comparing a share of stock to a can of tuna fish. If we whisper to you that we own a stock that just doubled, you would likely be interested in hearing the name and a brief description of its business. This assumption is probably an understatement -- based upon a cursory review of Internet stock message boards, you probably would rush out and buy it without the brief description.

What if we were telling you that the price of tuna fish has just doubled? Would you rush to Safeway to stock up? You are more likely to decide that the tuna is overpriced. You might even reduce your consumption until tuna has returned to its "normal" value. If the price of tuna is cut in half rather than doubling, you might perceive that it's a good value and buy more than usual.

In the speculative phase, people with nothing but dreams meet with people with nothing but money and exchange commodities.

With "real" goods, our brains somehow avoid mere extrapolation of recent price trends. With investments, the opposite occurs, and the gaming aspect of speculation takes over. Trends, once perceived, are expected to continue. Investors were extolling the superiority of the Japanese business model in the late 1980's, just before a two-thirds decline in the Japanese stock market. Ten years ago, the Japanese were hard working, hard-saving industrial supermen, in sharp contrast to the lazy, uneducated Americans. Now, Americans are perceived as hard working, entrepreneurial technology supermen, in sharp contrast to the Japanese, mired in a 10-year depression.

With tuna fish, our brains perceive a true, central value, around which the price fluctuates. Stocks are simply pieces of ownership of businesses. Each business presumably has a true value as well, around which stock prices will fluctuate. As with tuna, the higher the stock price, the less attractive it is from a valuation standpoint. In practice, however, we get more excited and more willing to buy a stock the longer its price goes up. Market rises often end in a speculative phase, where people with nothing but dreams meet people with nothing but money and exchange commodities.

As stocks begin to fall from a bull market peak, every decline is regarded as a buying opportunity -- stocks, even though selling at far above true business values, are thought to be cheap relative to the prices at the peak. The farther stock prices fall, the more discouraged investors become. After a long bear market, business may be selling at prices far below their true values, but fearful investors are not interested.

This psychological cycle is illustrated in the enclosed chart from Ned Davis Research, showing the percentage of household financial assets invested in stocks. People steadily increased their ownership of stocks through the long bull market of the 1950's and early 1960's, reaching a peak of 38 percent of household financial assets near the market high in 1968. As a sharp bear market hit in 1969 and 1970, fear replaced greed in the minds of investors. Even though the Dow hit a new higher high in late 1972, the bloom was off the sentiment rose and investors progressively became more disenchanted. Household stock ownership hit its low of 11 percent in the middle of 1982 -- almost the exact blast-off point for the long bull market we have since enjoyed. Stocks recently topped 40 percent of household financial assets, higher even than the bubbly sentiment of the late 1960's.

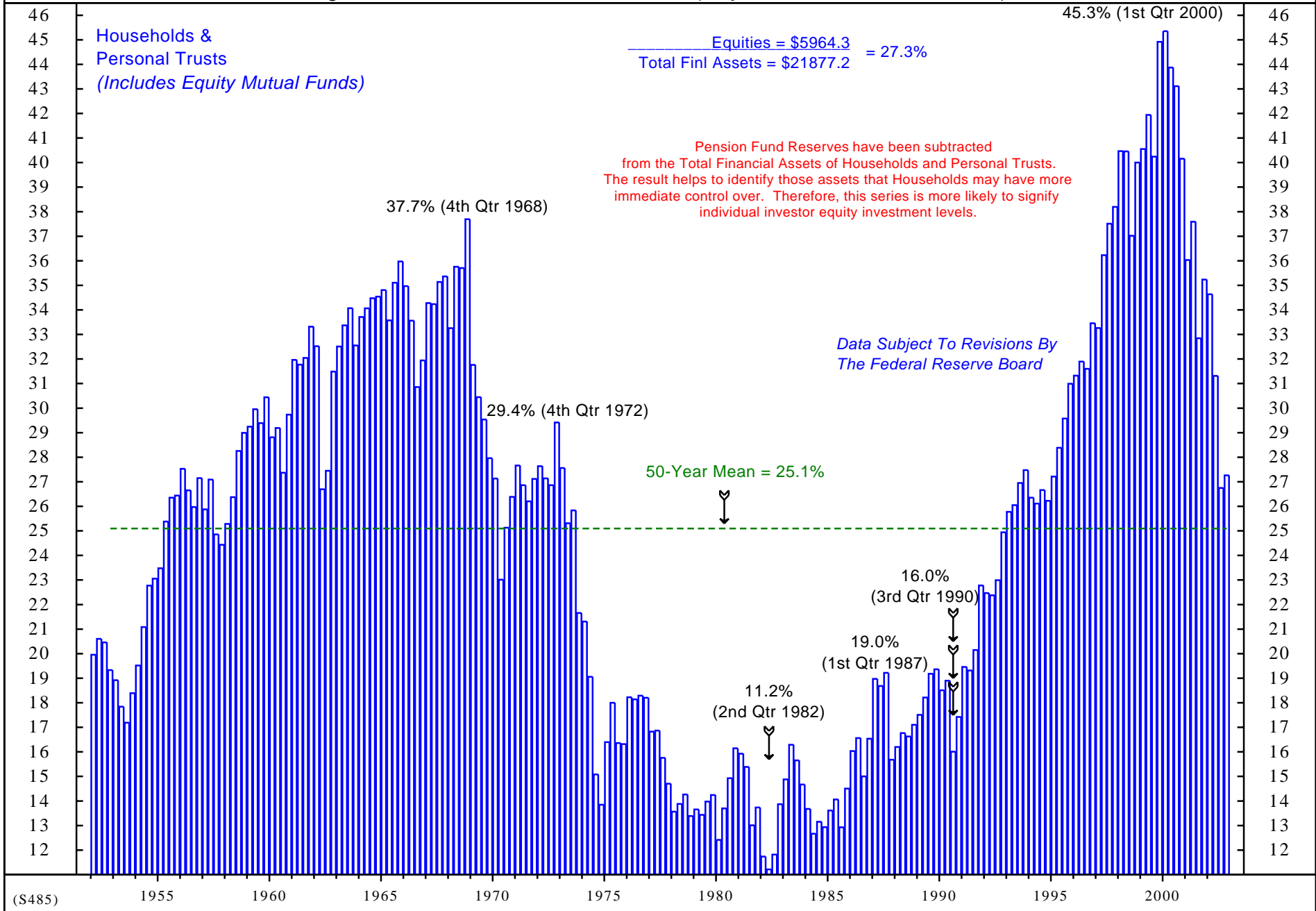
Joe Kennedy saved the family fortune by selling out after having a stock recommended by the person shining his shoes.

Institutional investors (pension funds and insurance companies) have been even more manic-depressive. Stocks as a percentage of institutional assets peaked at the market top in late 1972, with a low at the market bottom in 1974. Another peak percentage was "achieved" just before the 1987 market crash, with another trough at the lows of the Gulf War bear market in 1990. Of course, some of these fluctuations can be accounted for by market movements (as stocks go up, they represent a higher percentage of a portfolio), but the sentiment movements are unrelated to absolute stock market levels. For example, the peaks of 1987 and 1972 were at about the same sentiment levels, but stock prices were more than two and a half times higher in 1987. An all-time high of percentage of institutional assets in stocks was recently reached, about 50 percent higher than the sentiment peaks of 1972 and 1987.

The supply of tuna fish is relatively fixed, at least in the short run. In contrast, a lawyer and an investment banker can get together and create more stock on a moment's notice -- there will never be a "shortage" of stocks. Another way to interpret market sentiment is to ask who is left to buy or sell stocks. At the troughs of sentiment, almost everyone is a potential buyer of stocks. At the peaks, the fresh supply of buyers is running out. Legend has it that Joseph Kennedy, Jack, Bobby and Teddy's father, preserved the family fortune in 1929 by selling all his stocks after receiving a stock recommendation from the man shining his shoes. Joe realized that virtually nobody was left to buy.

We're not suggesting that tuna fish prices play a large part in our market analysis. If you're interested, however, in an investment approach that takes into account the valuations of your investments as well as the sentiment towards them, please contact us.

Stocks as a Percentage of Household Financial Assets (Adjusted for Pension Funds)



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