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## If Only We Knew Now What We Knew Then

A common fantasy is to be able to go back into the past knowing what you know now. Aside from winning a bunch of sports bets and making your prom night better, how would you live your life differently? We are going to suggest a fantasy in the other direction, pretending that we now know only what we knew at times in the past. This thought experiment was sparked by our observation of daily stock market commentary, as pundits try to explain the market's manic-depressive moods. The operating assumption each day is that if the market did something, it must have done it for a reason. If the market went up, the nightly news team looks at a list of ostensibly positive developments and selects one to explain the day's action. If the market is down, only negative developments are considered.

***“It’s a poor sort of memory that only works backwards’ the Queen remarked.” – Lewis Carroll, Through the Looking-Glass***

If we really pay attention, though, it becomes evident that just about everyone has it wrong. Wall Street firms spend a gazillion dollars a year trying to predict future fundamental figures such as sales, earnings and cash flows. What they fail to ask is how much difference would such knowledge really make in the investment programs of their clients.

At the end of July 1982, the Dow Jones Industrial Average closed at around 820. If we assumed that the index grew at the same pace as earnings, sales and cash flow (in the S&P 500 average) since then, the Dow would be selling at a little over 2,500. In other words, “reality” explains the move from 820 to 2,500, and our feeling better about our situation explains the move from 2,500 to the recent mid-January high of over 11,700. A perfectly prescient stock market analyst, correctly predicting earnings, sales and cash flows almost 18 years into the future, would have missed the bulk of the greatest bull market in U.S. history if she assumed we would be only about as optimistic as we were in 1982.

OK, maybe we were a little depressed in 1982. Instead, let’s move forward to August 1987, the giddy sentiment pinnacle of the 1980’s bull market, just before the October 1987 crash took 40 percent off the market. If we start at that “overpriced” peak and assume the index grew at the same rate as earnings, sales and cash flow ever since, the Dow would be selling at about 7,250, a good distance below recent highs. Of course, the stock market discounts the future, and market bulls will tell you the future is bright now. But we thought the future looked pretty bright in August 1987, too.

When Iraq invaded Kuwait in 1990, we became a little downcast again. If the Dow closing price at the end of July 1990 increased at the growth rate for earnings, sales and cash flow since then, the Dow would be selling at just under

6,300, a level nobody wants to see again anytime soon. Similarly, after the Federal Reserve raised interest rates several times in 1994, we had a flat year in the stock market – just about the only interruption in the bull market extending all the way since the Gulf War. Assuming the Dow average at the end of 1994 grew at the same pace as earnings, sales and cash flow, the current level would be around 6,500.

As a last example, let's go back about a year and a half to August 1998 -- hardly ancient history. If the closing Dow average that month grew at the same pace as earnings, sales and cash flow, the current level would be about 8,400. Not that our memories are perfect, but we do remember a little gloom in the 1982 and 1990 cases. In contrast, we thought we were relatively happy in 1994 and 1998, and really ebullient at the 1987 peak. Eliminating the two instances where we remember some melancholy, if we "knew" now what we knew at these earlier times when we were content or ecstatic, prices would be 28 to 45 percent lower than recent highs on the Dow. This raises the question of whether investors are as blindly enchanted now as they were despondent in 1982 and 1990.

***A knowledgeable fool is a greater  
fool than an ignorant fool.  
-- Moliere***

Our message is not to predict an imminent swing back to dejection but to warn against being, as the British put it so eloquently, "too clever by half." With a

lot of analysis, you may forecast future corporate earnings, sales and cash flow for a prospective investment. Even if your analysis is correct, however, how much do you really know?

The big swing factor in the rate of return for any prospective equity investment is whether we will be happy or sad in the future, not what earnings, sales or cash flows will unfold. Despite Dr. Freud's best efforts, this dependence on future emotions adds a large degree of randomness to the best-laid investment plans. Rather than worry obsessively over the subtleties in a model of future business developments, we would do better to practice humility and remember how we felt at times in the past.

Just about a year ago, the Dow first crossed the "magic" 10,000 level, giving rise to champagne cork popping and party hats (at least on CNBC). We recently crossed through the same level going the other way, without much hoopla by those nightly news anchors. Not surprisingly, Lewis Carroll in *Through the Looking-Glass* is more helpful than the top Wall Street analysts: "'The horror of that moment,' the King went on, 'I shall never, never forget!' 'You will, though' the Queen said, 'if you don't make a memorandum of it.'" If you would like some help in "remembering," contact us.