

April 2002

Is the Tide Coming In Or Going Out?

(The following is a speech given by Bill Berg, Sigma's president, in a March 1 discussion of the economy at a seminar sponsored by the Oregon Legal Management Association and the Oregon State Bar Law Practice Management Section.)

I am honored to be on this panel but somewhat skeptical that you take anything I have to say seriously. You see, I received my economics training in the early 1970's, and the only things I learned were:

1. IBM has a monopoly in the computer business;
2. GM, Ford and Chrysler are an oligopoly that completely controls the auto industry; and
3. Marxism is the appropriate economic model for developing nations.

You just received the same benefit I did from spending \$60,000 of my parents' money in today's dollars for tuition, so you are already ahead on the cost of this seminar.

***Economic data is worse
than useless for predicting
the stock market***

My business is investments, so I tend to see the economy through the prism of predicting the financial markets, a purpose for which it is worse than useless. Why worse than useless? Neither the free throw percentage of the Boston Celtics nor economic indicators predict the stock market. Nobody is tempted to use the former for that purpose, while everyone seems convinced the latter works.

The government's ten leading economic indicators have a good record of predicting the economy. The one with the best batting average is the stock market. The stock market predicts the economy, not the other way around. Every time you turn on the television and people are using economic data to predict the stock market, turn it off and spend the time playing with your kids or in some other worthwhile endeavor.

The consensus view is that the economy has bottomed and we are now starting a new upswing. Many indicators tell that story, and the market rise since late September 2001 agrees. But what of the longer view? If we have a cyclical upturn, is it within the context of continuing the long, secular rising trend we have been enjoying in the financial markets and the economy since the early 1980's, or starting a long, secular flat to down period?

Most investment and economic reporting focuses on what will happen tomorrow or next quarter. The longer view tends to be ignored. Most economists seem to assume that an upturn will be the next chapter in the wonderful economic

growth and beneficent financial markets we have been enjoying for two decades. While that is certainly a possibility, perhaps even a probability, it needs no discussion here. You can get that viewpoint by turning on CNBC at random and listening for 30 seconds. Instead, I would like to set forth some evidence that we have entered a period that will be less exhilarating for both entrepreneurs and investors. The question I am going to address is not what the next ocean wave looks like, but whether the tide is coming in or going out.

Since the stock market predicts the economy, let us look at stock market valuation. The stock market, after all, is just the price you pay for underlying businesses. Like in most areas of life, buying cheap and selling dear are the way to go. The paradox is that we get more excited about the stock market the more expensive it is. Investors tend to treat the stock market as a luxury good, like art or jewelry, where you enhance your status by paying too much.

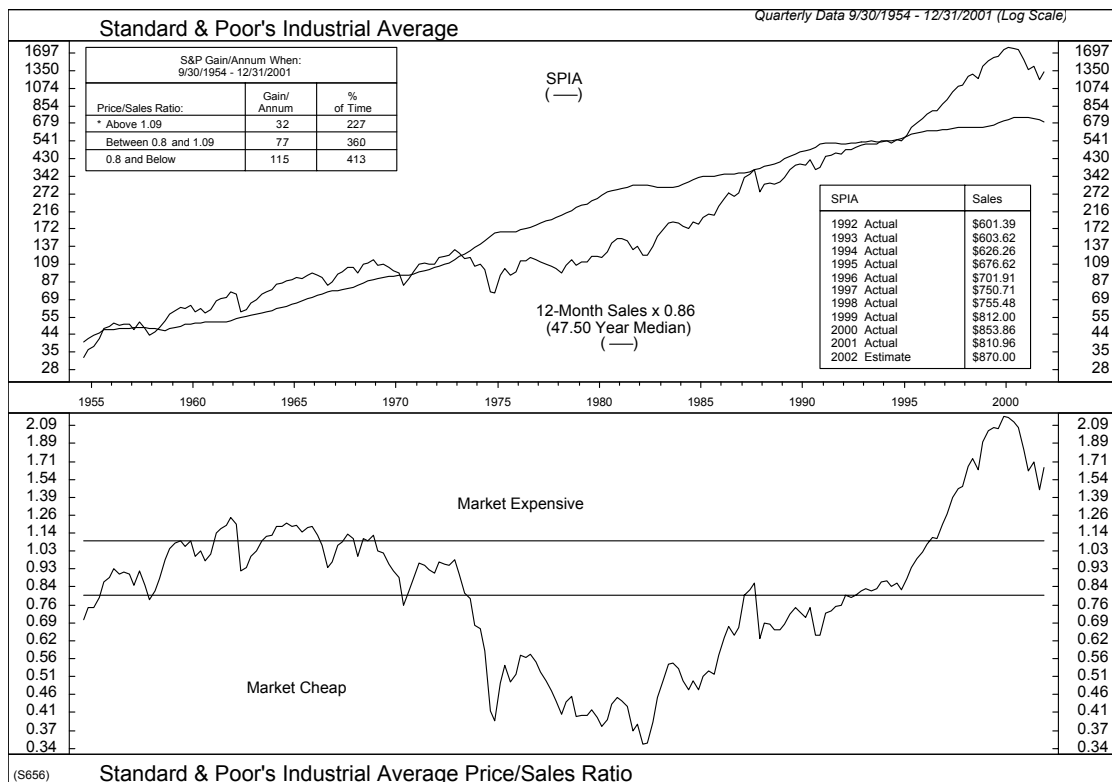


Chart source: Ned Davis Research

This is the S&P Industrial Index since the early 1950's relative to the price to sales ratio. I am using price to sales ratio since, in the post-Enron era, we do not know what earnings are anymore. Sales are a harder number for financial officers and accountants to finagle than earnings. As you can see, the market in general was expensive on a price/sales basis during the 1960's, which presaged a choppy to bad economy and financial markets in the 1970's. In the 1970's, the stock market became quite cheap, which presaged the good economy and markets we have had since. By this measure, and by just about any other classical valuation measure you can find (e.g., price/earnings, price/cash flow, price/book value, price/dividend), the stock market is now less expensive than it was 2 years

ago, but still quite expensive in a historical context. From a valuation standpoint, there is evidence here that the tide is going out on a secular basis for the economy and financial markets.

The next chart illustrates psychology or sentiment by showing stocks as a percentage of household financial assets. In the curve on the chart, you can see similarities to the valuation chart – there was a peak in the 1960’s, with stocks reaching 38 percent of household wealth in 1968, and then a trough through the 1970’s and early 1980’s with a low in 1982 at 11 percent. The decade of the 1980’s was one of the best decades in US history for stock market returns, but you can see that household investors mostly sat out the 1980’s, still intimidated out by their experience in the 1970’s. They did not get excited about the market until the tech boom of the late 1990’s. Just as in the valuation chart, we appear to have come off the peak in early 2000. Since this measure of sentiment seems to flow in long cycles, it appears the tide is going out here, too.

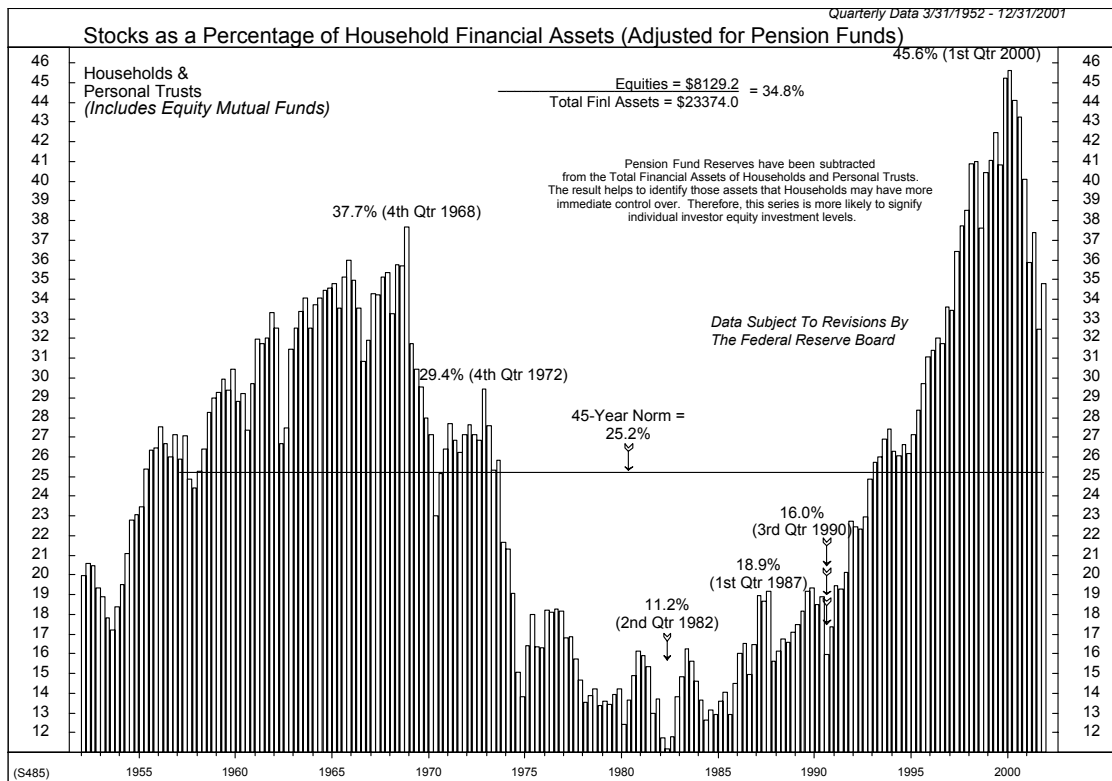
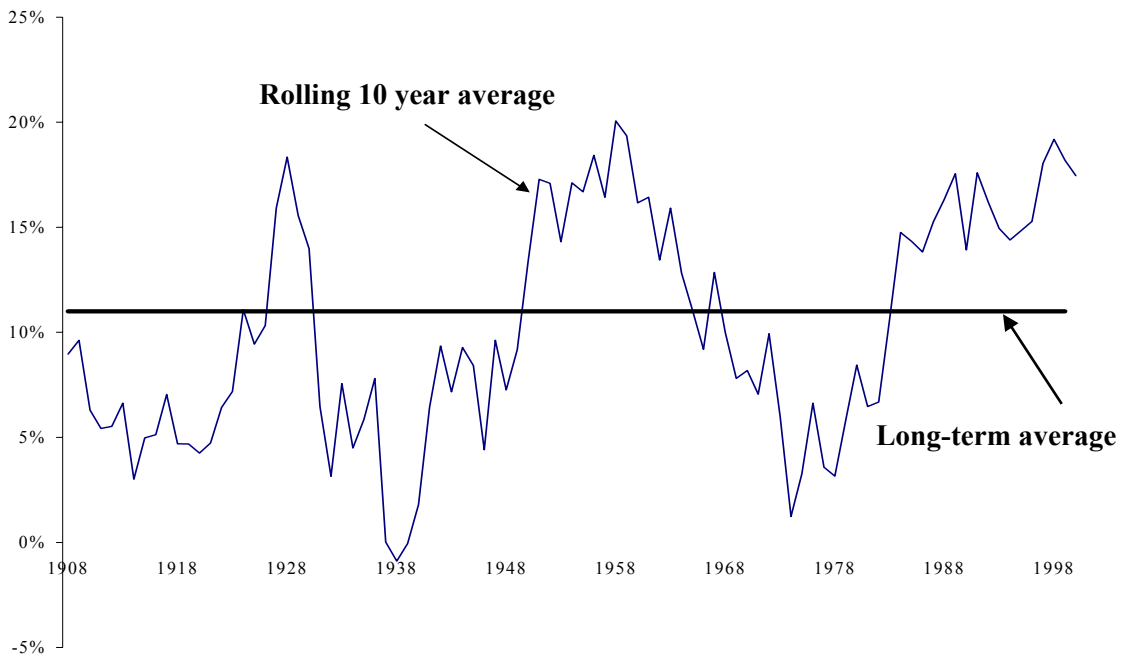


Chart source: Ned Davis Research



The last chart shows broad price trends for the last century, with each point on the chart representing the 10-year average annual total return on the S&P 500 index. While it is not a perfect sine wave, you can see similar long waves up and down -- which also correspond to broad, secular economic trends. The first peak was in 1929, followed by the Great Depression. The second peak was in the 1960's, followed by the stagflationary 1970's. We recently experienced what is beginning to look like a peak. Since I have a roomful of lawyers here, I can't help pointing out that the two most important pieces of legislation for the securities markets in the past century, the Securities Exchange Act of 1934 and ERISA in 1974, both roughly coincide with the low point of a cycle. Pain leads to transforming legislation. The definition of fraud and standard of due diligence under Rule 10b-5 of the 1934 Act were not defined by the courts until 1968, after the cycle peak when pain began to be felt again. When we hear retirement plan fiduciaries take comfort in the paucity of ERISA litigation, we point out that ERISA passed when the Dow Jones Industrial Average was at about 600, versus the peak two years ago of 11,700. The good news for you lawyers is that there will be a lot of litigation surrounding ERISA plans in the future. The bad news, taking into account your firm retirement plans, is that some of you might be defendants.

With that happy note, I will conclude. The charts of price trend, valuation and sentiment are starting to hint that the economic and investment tide has finished coming in and started going out. This is not disastrous news -- I was around in the 1970's and do not recall a lot of despair in day-to-day life. To a certain extent, we all tend to make a lot more rational decisions in that kind of sober environment. I am suggesting, however, that from an economic and investment standpoint, it would be a mistake to assume automatically that the next decade will be like the last two.