



May 1998

Jury Summation for the Defense

In this “new era,” caution has few supporters and even fewer followers. We are not market timers or “bears”, but we can’t resist playing the devil’s advocate, “defending” caution in a thought experiment “trial.” Here is our closing argument to the jury.

Ladies and gentlemen, you have heard the prosecution describe how stocks are wonderful investments for the “long run,” that the economy is in the best of all possible worlds, and that we are in a new “paradigm” where stocks can be bought with abandon, regardless of values. The defense, on the other hand, has demonstrated the following: (1) actual investors have not actually enjoyed the huge index returns flaunted by the bulls; (2) rather than predicting *future* gains, the current robust economy explains the *past* bull market and is already discounted in current prices; (3) even “blue chip” large company stocks can decline if they are bought at the wrong price; and (4) the current market is so richly valued that future gains are questionable.

The current bull market has been wonderful. The Dow Jones Industrial Average in August 1982 hit a low of 777, compared to a recent high above 9,200, an almost twelve-fold increase. Investors, however, have not reaped the full gains of this increase. In the 15 years ended March 1998, the average growth and income manager lagged the S&P 500 performance by 3.32 percent per year. According to a study by Dalbar, Inc., the average no-load equity fund investor actually achieved only about 42 percent of the performance of the average growth and income mutual fund!

The current bull market was accompanied by a decline in short-term interest rates from 16.75 percent to below 5 percent.

The twelve-fold increase in the Dow since 1982 has been accompanied by inflation falling from above 13 percent annually to less than two percent, long-term interest rates falling from above 14.5 percent to below six percent, and short-term interest rates falling from 16.75 percent to below five percent. These declines in interest rates and inflation have provided a tremendous tailwind for the stock market, but are these declines likely to continue? The stock market is losing this tailwind and will have to rely upon its own fundamental value and potential growth.

The bull market has also led to sharp increases in price levels relative to fundamental values. History provides many sobering lessons about investors ignoring value. In the early 1970’s, like recently, large company stocks were in favor. **Exhibit A** lists some of the favored large companies of that time, and how they performed in the subsequent bear market. In this list, the average price/earnings ratio for the stocks at their highs was 62. At the bottom of the bear

market in 1974, the average price/earnings ratio was 11. Much of the projected earnings growth occurred, but investors no longer cared in the teeth of a bear market. For emotion-driven growth stocks, punctured optimism can lead to severe declines.

How do current stock market valuations compare to the past? **Exhibit B** shows fundamental valuation measures for the S&P Industrial Average at two historically cheap periods, two historically expensive periods and now. The price decline of the S&P 500 following the expensive periods is also shown. By any of the three measures, the current market is even more expensive now than just prior to previous bear markets. The high valuations are not just focused on the blue-chips – the Nasdaq Composite sells at 66 times earnings, the Nasdaq Industrials at 94 times earnings.

***“There are no new eras, only eras carried to new extremes”
-- Robert Farrell, Merrill Lynch***

Corporate profits may even be inflated. For example, stock options are not recorded as compensation expense. If they were, just like wages, Smithers & Co. concluded that profits for the 100 largest companies would have been 36 percent lower in 1996, and Intel and Microsoft would have shown *losses* rather than profits.

Stock market bulls tell us that such valuation measures can now be ignored because we are in a new era. Here is some expert opinion on this topic:

Minutes of the Federal Reserve: “There is no means of knowing beyond question how far this recent rise in stock prices represents excessive speculation and how far a readjustment of values to increased industrial efficiency ... and larger profits.”

Forbes magazine: “As the result of all that has been happening in the economy...during the last decade, we are in a different – if not a new – era and traditional thinking, the standard approach to the market, is no longer in synchronization with the real world”

Unfortunately, the Federal Reserve minutes are from 1928, before the 1929 crash and ultimate 89 percent decline in the Dow. The Forbes quotation is from October 1968, the beginning of a six-year decline of 60 percent, adjusted for inflation. Ladies and gentlemen, we may be in a new era, but stock market turning points are always accompanied by wrong-headed new era thinking. Are you willing to bet your future that this time really is different?

This letter is not a market prediction, and most of the arguments could have been made two years ago at much lower market levels. Investors recently getting more aggressive in response to the rising market, however, had better believe in the “new paradigm.” All the old paradigms raise at least the possibility of sub-par returns on equities. For further reflection, contact us.

Exhibits -- Jury Summation for the Defense, May 1998

Exhibit A – Selected “Blue Chip” Stocks in the 1973-74 Bear Market

Stock	1973–74 Decline	Stock	1973–74 Decline
Automated Data Processing	-79.2 %	McDonalds	-72.5 %
Avon	-86.7 %	National Semiconductor	-82.8 %
Clorox	-79.6 %	Polaroid	-90.6 %
Data General	-78.6 %	Sony	-78.1 %
Disney	-86.0 %	Tandy	-80.1 %
Dr. Pepper	-78.3 %	Wal-mart	-78.6 %
Electronic Data Systems	-87.8 %	Westinghouse	-85.4 %
Marriott	-83.9 %		
Average Decline			-82.6 %

Source: David Dreman, Psychology and the Stock Market

Exhibit B – Market Valuation Comparisons

	<i>“Cheap” Markets</i>		<i>“Expensive” Markets</i>		
	Low 12/6/74	Low 8/12/82	High 1/11/73	High 8/12/87	Current 5/1/98
Price/Earnings	7.5	7.5	19.7	19.2	31.0
Price/Book Value	1.07	0.95	2.31	2.94	7.8
Price/Dividend	19.4	16.3	41.8	44.8	76.9
Subsequent Decline	N/A	N/A	-48.2 %	-33.5 %	?

Source for Federal Reserve minutes and Forbes quotes in newsletter text: The Economist, April 18-24, 1998.