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O Nasdaq Earnings, Where Art Thou?

As “new era” stock market skeptics, we are frequently asked if we have turned bullish, given the stock price declines of the past year. The Nasdaq Composite fell more than 68 percent in only 13 months from its high in March 2000, perhaps the most severe short term decline for any major U.S. stock average in history. From the high in 1929 until the low in 1932, in what many consider the worst bear market in U.S. history, the Dow Jones Industrial Average (which included many of the glamour stocks of that era) fell 89 percent but took almost three years to do so. Given our contrarian instincts, a rapid 68 percent decline gets us looking for opportunities.

***Rally-Chasing Rule #1:
Eagles may soar, but foxes
aren't sucked into jet engines.***

The ultimate economic effects of the drop have yet to be determined. The Nasdaq Composite alone lost more than 3 trillion dollars, equal to all the savings of every person in the U.S. during the entire decade of the 1990's. From 1982 through 2000, the Standard & Poor's 500 index had never had a daily close below the low of a preceding year. This year's low for the S&P 500 was below the lows for both 2000 and 1999. When the market does something that it has not done in almost two decades, it is worth taking note. On the bright side, both the advance and decline were relatively narrow. Only 11 stocks (all on Nasdaq) were responsible for half of the U.S. stock market's gain in value between the end of 1997 and the market's peak last year. The same 11, in turn, accounted for half of the market's loss to the April 2001 lows.

The discipline that kept us skeptical of the new era chatter a year ago was a focus on underlying business fundamentals rather than short-term sentiment and momentum. For example, while the momentum peak for the Nasdaq Composite occurred in the apogee of the technology mania in late 1999 and early 2000, a recent analysis by Ned Davis Research, a leading institutional research firm, tells us that the Nasdaq's trailing 12 month earnings peaked in June 1997. What are the fundamentals telling us now? The steep Nasdaq price decline was actually exceeded by the decline in the earnings of the component companies, down 79 percent through the end of the first quarter this year. Despite the severe market drop, the valuation of the index, measured by earnings, actually became worse, with the price/earnings ratio rising to more than 280 in March 2001, many times greater than the typical historical ratio.

Why are we reaching back to March data for a price/earnings ratio? Because it's the last month with a positive ratio. By the end of April, the reported composite earnings for all the companies listed on Nasdaq were negative. If anything, earnings may be overstated, since Ned Davis Research points out that,

when a stock is delisted on Nasdaq, they also remove its earnings history. So all those Internet companies that have gone defunct are now treated as if they never existed. In addition, many of the Nasdaq stalwarts have been prolific users of earnings-boosting accounting rules (for stock option plans and the like) that result in higher earnings than common sense might dictate. Market bulls like to use a different price/earnings measure for Nasdaq that excludes the component companies with negative earnings. Sure, and we like to use an alternative scoring method for golf where we get to exclude all our bad shots. Even this "new era" measure shows the Nasdaq price/earnings ratio at 27 compared to a 15-year bull market average of under 18.

***Rally-Chasing Rule # 2:
The early bird may get the
worm, but the second
mouse gets the cheese.***

Of course, the market isn't priced on past earnings, but looks forward to discount the future. Sometimes P/E ratios are high during recessions as investors begin to look over the valley for a potential upturn.

While we can hope this is true, we wouldn't place a lot of faith in this optimistic scenario. In general, Wall Street analysts are paid to be bullish (more stocks are sold that way, generating commissions). As a group, they never saw the decline last year coming. For example, technology analysts last December expected first quarter 2001 profits to grow by 15 percent. Two months later, their forecast had been revised to expect an 18 percent earnings decline. Any crystal ball that cloudy hardly inspires confidence. If they didn't foresee the decline of the last year, why should we trust them to predict when the bottom occurs?

Sentiment has remained relatively bullish throughout the decline, a condition not normally consistent with a market bottom. The sharp decline, especially among the speculative favorites, may have dented the belief that stocks can only go up. Market professionals, however, will have to overcome the conditioning of the past decade, in which the "right" decision was always to throw money at stocks any time there is a decline. This organizational tendency is hard to measure by surveys, but we believe it helps explain the dramatic intermittent rallies that have punctuated the sharp declines of the past year.

So the "new era" argument still rages on. Bears point to the declining profits of the technology sector and Nasdaq as a whole, the lack of visibility as to what is going to turn the earnings around and the complacency of investors that will have to be shaken before a bottom is put in. Bulls point to the Federal Reserve lowering interest rates and pumping money into the financial system, the prospects of a tech turnaround and the complacency of investors that indicates their understanding of long-term investing. Our crystal ball is as cloudy as everyone else's, but if you know someone who might appreciate the perspective of people who warned about the mania before it collapsed, have them call us.