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Question: With the Stock Market Hitting Records, Why Aren't I More Happy? Answer: We've been Framed!

Newspaper headlines and the brief market updates we get from television news shows largely determine our notion of how the stock market is doing. The headlines and anchorman snippets, however, only report on one segment of the investment universe -- large company stocks in the U.S., as measured by the Dow Jones Industrial Average, Standard & Poor's 500 or Nasdaq Composite. Beginning in 1995, large U.S. stocks have performed better than small stocks, foreign stocks and bonds in each calendar year. This has had two effects. First, investors with any investment other than large company stocks feel like they are being left behind, and that "everyone" is doing better than they are. Second, there has been a rush to invest in large company stocks as a chorus of investment pundits disparages diversification and asset allocation.

***Which "market" do you follow?
The S&P 500 was up more than
18 percent, but the average
New York Stock Exchange
stock was down 14 percent.***

These two effects result from a phenomenon that psychologists call "framing." Our thoughts about the market are framed by how the market is reported. Since the performance of large stock indices is all that is reported, we consider these to be "the market." This completely ignores small company stocks, foreign stocks, bonds and any other type of investment. Market history tells us that small company stocks have had a higher return than large company stocks and that adding foreign stocks to a portfolio tends to reduce portfolio volatility and might increase returns as well. Bonds provide income, some stability and a hedge against a falling stock market. These lessons of history are now forgotten in a barrage of record highs reported for "the market."

In the 12 months ended March 31, the Standard & Poor's 500 index had a total return of over 18 percent; but the average stock in the index had a total return of just 0.5 percent, and the average stock on the New York Stock Exchange fell 14 percent. If your portfolio broke even for the period, you did far better than the average stock, but felt terrible because you lagged "the market" as framed by the index. Just the reverse happened in the late 1970's as smaller US stocks outperformed the large stock indices. Sentiment was subdued, but investors were making money in a stealth bull market. We have recently experienced a stealth bear market as the average stock has performed much worse than the reported averages.

Think about the "framing" issue from the standpoint of an overseas investor. A Swiss investor who diversified into the US market is probably much

happier with the idea of diversified asset allocation than the typical US investor. An investor in the US who only held small stocks a few years ago and decided to also buy large stocks is also probably happy about his "diversification." The perceptual problem is that our starting point is the over-reported cluster of big stock averages. No competent financial planner would suggest having all your investment eggs in that one basket.

For all the focus on the economy and corporate earnings, investor sentiment is a much greater swing factor in stock market returns.

Investment analysts estimate earnings for the companies they follow. Add together the individual estimates for index component companies and you get an estimate for the S&P 500. In the May 3 issue of *Forbes*, David Dreman reported on a study of analyst projections since 1982. The average estimated earnings gain for the S&P 500 each year was 22 percent, but the actual gain was 7 percent. Dreman's point was to make you skeptical of analyst projections, but his study illustrates another critical point about the bull market we've been enjoying. Stocks rise and fall each day based upon whether or not earnings meet or exceed analyst estimates (or even worse, the "whisper numbers" of what people expect), and these estimates frame our expectations for stock performance. The entire focus is on trend, not absolute levels. Not many investors seem to place these earnings in a larger context of illusion versus reality.

The Dow Jones Industrial Average in August 1982 traded at around 780. Compound this by the 7 percent earnings growth since 1982 and you wind up with a "value" (using 1982 earnings multiples) for the Dow of about 2,500. The increase from 780 on the Dow to 2,500 reflects actual earnings gains. The increase from 2,500 to recent highs above 11,000 on the Dow only reflects how much better we feel about those earnings than we did in 1982. For all the focus on the economy and corporate earnings, investor sentiment is a much greater swing factor in stock market returns. Even if corporate earnings grow, if we feel worse about the world, our investment returns will suffer. After all, this is just the flip side of the 70 percent total return for the S&P 500 in 1997-98 while earnings declined.

The biggest "frame job" investors face is that our brains are wired to extrapolate recent performance into the future. Investors in 1982 were too depressed because the market had been declining since the mid-1960's, with inflation eating away at purchasing power. Economic forecasts were bleak. A *Business Week* cover story proclaimed "The Death of Equities" and gold, oil and real estate were considered the premier investments. Now, after 17 years of rising markets, we feel like geniuses, amazed at the obviousness of the factors behind the long bull, and confident (based upon rosy economic forecasts) that the good times will continue. Investors were clearly too depressed in 1982, but are we too ebullient now?

If you want to develop a rational investment plan that avoids being "framed," contact us.