

September 2001

Only Yesterday

Given the enormity of recent events, we'll apologize in advance for the seeming triviality of focusing on the financial markets. Others have expressed our thoughts and feelings about the terrorist attacks on the World Trade Center and Pentagon far more eloquently than we ever could. The reactions of the financial markets, however, *have* been part of the news story.

"They terrify, lest they should fear"
-- Tacitus

Much of the commentary surrounding both the financial markets and America's place in the world indicates that September 11 marked a turning point, a day that changed everything. This reminded us of a passage from Frederick Lewis Allen's history of the 1920's describing the effects of the 1929 stock market crash:

"Prosperity is more than an economic condition; it is a state of mind. The Big Bull Market had been more than the climax of a business cycle; it had been the climax of a cycle in American mass thinking and mass emotion. There was hardly a man or woman in the country whose attitude toward life had not been affected by it in some degree and was not now affected by the sudden and brutal shattering of hope.... Americans were soon to find themselves living in an altered world which called for new adjustments, new ideas, new habits of thought, and a new order of values."

--Frederick Lewis Allen, *Only Yesterday* (1931)

Perception and reality in the financial markets, as in life, are often at odds. Only yesterday (before September 11), the perception was that flying was very safe, and yet it was not. Today, the perception is that flying is not safe, and yet it is immeasurably safer than a month ago. Only yesterday, little was being done to thwart the possibility of biological, chemical and nuclear terrorist attacks on our country. We now fear such attacks more, but the risk is reduced since protecting against the attacks is among the top priorities of the nation.

Only yesterday, the economy was rapidly sliding into a recession, if it wasn't already there. Government tax and spending policies, however, were constrained by the politics of the fictitious accounting for the Social Security trust fund. We are not now, nor have we ever been, followers of the Keynesian school of economics, but the situation could have exacerbated the recession into something worse. The trust fund "lockbox" conundrum is now a thing of the past.

Only yesterday (actually, eighteen months ago), the perception was that aggressive investing was without much risk, and yet it was very hazardous. While nobody can predict the ultimate bottoming of the recent decline, clearly stock prices today better reflect the business prospects for the underlying

companies than they did in March 2000. Despite expanding anxiety, investing is now safer.

When the United States prepared for the Gulf War, the economy was working through the excesses of the acquisition and junk bond mania, savings and loan debacle and Los Angeles/Boston/New York real estate booms of the late 1980's. The decline in confidence that accompanied the preparations for war accelerated economic trends already in place. We believe a similar condition exists today. The stock market decline since early 2000 reflects the process of working off the excesses and malinvestment of the Internet bubble and manic technology boom of the late 1990's. The decline in confidence resulting from the terrorist attacks may accelerate the pre-existing trend. While the war on terrorism will affect sectors of the economy, it is not at all clear that it will have major effects upon overall economic activity.

***Speculation is the self-adjustment
of society to the probable
– Oliver Wendell Homes***

There has been a strange bifurcation in the reaction of the financial markets to the terrorist attack. While the stock market decline has quickened in the wake of the terrorist attacks, the data available as this is written seems to indicate that the selling has largely come from professional investors. Whether this is because non-professionals are more steely-nerved than the professionals or are just in shock remains to be seen.

Periods of great stress are not the time to change a strategy that has been rationally determined. On the other hand, almost any time is a good time to fix a mistake. Investors who were conservatively (correctly, we think) positioned before the terrorist attack should not double-count their conservatism by further reducing their equity positions simply because they were proven correct. Investors who were too aggressively positioned before should correct that error to the extent the market has not already done it for them.

We do not believe that economic reality fundamentally changed on September 11, but perceptions changed dramatically. Perceptions are not trivial -- Franklin Roosevelt's observation that "the only thing we have to fear is fear itself" was not empty rhetoric. Prosperity *is* a state of mind. The shattering of a pleasant fantasy can be painful, whether the illusion is that our country has no enemies, that the fall of the Soviet Union was the "end of history," or that huge gains easily made in the stock market would allow us all to retire early. But fantasies are unlikely to lead to progress. Only yesterday, our focus was on the Powerball jackpot, "reality" TV, Gary Condit, and who wore what gown to which awards show. The paradox of the financial markets is that today's more realistic and clear-eyed view of the situation we face should lead to a better tomorrow.