

November 1996

Emotions and Investing II -- Are You Now, Or Have You Ever Been, a Bear?

After a buoyant, speculative, technology-driven stock market was destroyed in a 36 percent market decline in 1969-70, institutional investors renounced their speculative ways and flocked to buy large companies with “visible” earnings growth. This “buy good stocks and hold them” philosophy led to what is known as the “nifty fifty” market in 1970-73. Major brokerage firms had lists (of about 50 names) of large company growth stocks that the professionals bought to the exclusion of other, cheaper stocks. The expensive stock prices of these leading corporate citizens were decimated in the 1973-74 bear market. We have a list of certain of the “nifty fifty” stocks, including Disney, McDonalds, Polaroid, Wal-Mart and Westinghouse, that declined an average of 82 percent, much worse than the 48 percent decline in the Standard & Poor’s 500 index during the same period.

In 1973-74, the “buy good stocks and hold them” strategy favored by institutional investors led to an average decline of 82 percent.

The “nifty fifty” market demonstrates that professional investors are not exempt from the emotionally-based “groupthink” dangers we described last month. This came to mind as a result of reading criticism by pundits of anyone who does not think the market is going straight up forever. It reflects how benevolent the markets have been that anyone suggesting the markets are, at least sometimes, a two way street is regarded as a “bear.” In the mature stage of any market cycle, up or down, the emotional strain of trying to explain why “this time it’s different” leads the market crowd to regard those not fully agreeing with them as not only incorrect but sinister. After a long bull market, bears are so hard to find that criticism lands on anyone not believing the law of gravity has been repealed.

Upon seeing our recent market valuation analysis, certain market professionals questioned why we would show it to prospects or clients. The implication is that we should be focused not on the long term good of our clients, but the short term good of our revenue stream. Emotions in a speculative, performance-driven environment lead investors to focus on comparing relatively short term performance numbers, regardless of the potential long term risks assumed to achieve those numbers. In response, many market professionals do not allow themselves the luxury of looking at things like historical valuation measures, so they rationalize by denying their possible validity.

This is not just a problem for investments sold to the public. Institutional investing is now largely driven by consultants who are retained to hire and fire investment managers. Consultants, who often have less investment experience than the managers they are evaluating, are hired to know more about the managers

than their clients know. They therefore avoid managers who may shift investment allocations due to market conditions in a way the consultant cannot predict.

As a result, many investment managers face a dilemma. They can pursue a course they believe is correct (being cautious in an expensive market), with the result that they will be fired by the consultant. Even if they prove to be correct and the market declines, they will never be hired back by the consultant because they lack “purity of style” in their approach. On the other hand, they can do what they believe is wrong (staying aggressive in an expensive market), knowing that even if the market suffers a severe decline, they will be favored by the consultant because they behaved as the consultant predicted.

The exclusive focus on recent performance and the demands of consultants can act as a shove in the backs of the lemmings as they rush towards the cliff.

The exclusive focus on recent performance by the public and the demands of consultants can act as a shove in the backs of the lemmings as they rush towards the cliff. Investment managers assume far more risk than they otherwise

would. Even if you do not believe the managers can correctly predict the market, this is a major change in manager behavior that has yet to be tested by a sustained bear market. It is akin to a lawyer following the legal strategy suggested by his client for fear of the client hiring a different lawyer.

The point is that professional investors are subject to the same emotional weaknesses we described here last month. In the early stages of a bull market, actual performance exceeds the emotional sentiment of investors. In the late stages of a bull market, emotional sentiment exceeds actual performance.

History is clear -- markets are not likely to go up forever. We must be prepared for the financial and emotional concerns of our clients when the market is not as benevolent as in the recent past. We do not believe that rationally appraising the markets, heeding the lessons of history or tilting towards areas of relative value means we are market timers or bears. The way we invest, being bullish or bearish is not the main issue. Despite notes of caution in our newsletters, our client accounts have substantial equity holdings. We realize that equities have to be the cornerstone of any growth account. We simply believe a market outlook that does not take into account the possibility of being wrong is a recipe for disaster. If this makes sense to you, contact us.