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The Importance of Being Humble

(Editor's Note -- This month's newsletter consists of the text of a speech given November 9, 1999 by Bill Berg, Sigma's president, in San Francisco on a panel jointly sponsored by the alumni associations of the Harvard, Stanford and UCLA business schools. Bill's co-presenters were Ron Elijah, manager of RS Value + Growth Fund and Ken Fisher, CEO of Fisher Investments, Inc., and regular Forbes magazine columnist)

It is, perhaps, a stock market indicator that I have been selected to fill the "bear" slot of this program, given that I am not a bear. All the real bears apparently demurred. This isn't all that surprising -- to publicly admit being a bear these days means you are confessing that you have been very wrong on the markets for some time now. We may be in a new era, but, contrary to some market pundits, human nature hasn't changed much, and nobody likes to admit to being wrong.

To be bearish on the markets today means confessing you have been wrong on the markets. Nobody likes to admit to being wrong.

I will admit, however, to having been somewhat cautious during a period in which caution has not been rewarded. Sigma allocates client assets among investment managers, based upon a target asset allocation we set up with each of our clients. For each investment category, we have a range in which we "tilt" the portfolio based upon both valuation and momentum indicators. The momentum indicators are now telling us the opposite of what the valuation indicators tell us. The magnitude of the valuation disparity, however, has led us to have, on the margin, a cautious stance.

I'll explain in more detail the reason for our caution in a minute. Since my assignment was to present a bearish case, though, I'm going to summarize a December speech by Dwight Rose, a "quant" analyst at Brundage, Story & Rose before a joint meeting of the American Economic Association and the American Statistical Association. When he started his speech, he noted that some of the audience was leaving and questioned if they were running out to the lobby to phone their brokers given the optimistic forecasts of the two bulls preceding him on the dais.

I like Rose's analysis because, unlike many perma-bears, he is not rooting for the end of western civilization. Dwight just points out some commonsense factors that are easy to forget in a rampant bull market environment. Rose comments in his speech about the amazing shift in investor attitudes towards investments -- in contrast to just a few years previous, when he was having great difficulty convincing clients to invest in "risky" stocks, he is having great difficulty convincing clients to invest in anything other than stocks. His analysis looks at three items:

(1) the success investors actually achieved over the previous 25 years during the roaring bull market;

(2) the fundamental qualities that have led to the tremendous stock market success; and

(3) the extent to which changes in these fundamental qualities have altered the attractiveness of stock investments.

> ***Business people agonize over a potential acquisition with an earnings return of 20 percent but throw money at stocks with an earnings return of five percent.***

With respect to the first point, Rose analyzes a database of large institutional investors and finds that the institutions performed far worse than the returns that theoretical studies indicate investors should have earned. Virtually all the large gains came in the last six years of his study. So most investors hadn't done as well as what we call "the market." The human brain tends to extrapolate the recent past, however, so investors base their expectations primarily on those six great years rather than a more realistic judgment based upon either longer term history or actual investor experience.

On his second point, Rose's analyzes the qualities that have led to the great bull market. At the bull's beginning, interest rates and commodity prices were historically high. As they declined, stock market investments had a substantial tailwind. These declines were accompanied by seven years of expanding credit and unusual economic prosperity. But can this tailwind continue? Dwight points out the probability that the interest rate and inflation declines are already factored into stock prices.

Finally, Rose looks at fundamental changes in common stock investments. The bull market started when stocks were selling at low multiples of earnings, but, as he was speaking, they are at record highs. Dwight acknowledges the bullish view that there's a new era in which corporate management restructures away waste and applies new technologies. Rose gives these innovations their due, but asks if the primary beneficiary of restructuring and technology isn't the consumer, not the investor. He also questions whether these favorable factors have already been discounted in an inflated market price, pointing out the paradox of business managers agonizing over acquisitions with a return on equity of 20 percent but throwing money into stocks with an earnings yield of 5 percent.

Rose suggests that, as rosy as things seem, eventually something will go wrong. There are two possible outcomes. First, confidence in the stock market will be shaken and the underlying businesses will once again priced at eight or nine times earnings, leading to investor losses of around 50 percent. Second, the new era people are right, but with valuations already high, stock market returns are limited to earnings growth in the underlying businesses. If the second alternative is the case, the competing yield from bonds looks pretty attractive.

So that's the bearish case from Dwight Rose. Oh, did I tell you that Mr. Rose's speech was given on December 27, 1928? Dwight looked pretty foolish the next year, as the Dow Jones Industrial Average climbed more than 31 percent to its high on September 3, 1929. He was also wrong on the downside. Rose spoke of the possibility of a 50 percent decline from the date of his speech. The actual Dow decline to the low in July 1932 was a little over 85 percent. The Dow didn't get as high as the date of his speech again until 24 years later, on the next to last trading day of 1952.

The market finds ways of humbling even its most serious students.

The point of this parlor exercise is not to put forth Dwight Rose as some kind of genius, whose wisdom we can follow today like the prophesies of Nostradamus. There were equally convincing bearish cases made in December 1974, at the dawn of the bull market we have been enjoying. For that matter, I could have written this speech three years ago. My point is that the start of wisdom in investing is acknowledging the possibility, if not the probability, that you will be wrong. The stock market has a habit of humbling even its most serious students, from the members of this panel to Warren Buffett. Given that you are going to be wrong some of the time, your analysis and your behavior better take that risk into account.

Unfortunately, being humble is not rewarded by the media -- talking heads on TV always state their opinions with an air of certainty. On a personal note, when I was an investment banker, my first big deal was for Financial News Network, the predecessor of CNBC. Given the views I'm expressing now, it's a little like Igor, Dr. Frankenstein's hunchbacked assistant, appearing on a talk show to expiate guilt by talking about how he now realizes those experiments were *wrong*.

There is a lot of debate now about the relevance of certain traditional stock market valuation measures, such as dividends and book value, in today's information age. We looked at dozens of fundamental valuation measures from Ned Davis Research, relating stock prices to adjusted earnings, sales, cash flow, etc. and asked the question of how far the stock market would have to fall to reach "normal" levels for each measure. The average decline to reach normality was around 58 percent. What surprised us is how tightly bunched the indicators were. Our conclusion from this is that it is a waste of time to argue about the merits of any given indicator -- they are all telling you the same thing, that the market is very richly priced by almost any indicator of business value. Like Dwight Rose, that limits our alternatives. First, the market may fall. Second, the market may flatten out while earnings catch up with valuations. Third, we may be in a new era during which stock prices are permanently unhinged from business values.

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Unfortunately, even if you still believe in valuation measures, they don't tell you much about market timing. Our work tells us that stating that the market is expensive does not tell you much about what happens next year -- markets get momentum and keep on rolling (although for unpredictable periods), even though they are expensive. They were excellent predictors of average returns for the next 10 years, however. Thus we have the conclusion, unsurprising in any area of human endeavor other than investing, that buying when things are expensive is worse than buying when they are cheap. Just because their predictive power is in the long run doesn't mean the valuation indicators are worthless. After all, would Custer rather have a scout tell him that there were "too many" of the enemy coming fast 30 miles away, or exactly 2,524 over the next rise?

This century, there have been three super bull markets -- the one that ended in 1929, the one that ended in the 1960's, and the one we are enjoying now. In the late 1920's and the late 1960's, everyone was talking about new eras too. In fact, one of the primary rationales for the supposed new eras was technology. I think the Internet and computer advances are wonderful, and I enjoy them every day. In the late 1920's, the new technologies included electricity, the incandescent light bulb, radio and the automobile, and they were pretty important too. In the 1960's, computers and the transistor were transforming the business world. But they didn't lead to new eras for investors, at least the kind of new eras they wanted.

As much as I enjoy using the Internet, I am again burdened by my memory. In early 1983, a tremendous speculative boom in PC stocks was underway. When you look at the winners of the PC boom, however, you reach a sobering conclusion. Microsoft, Compaq and Dell all went public substantially after 1983. When everyone was frantically playing the game, the names were Eagle and Kaypro computers. Almost all the speculative favorites of the time went bust. PC's were a very important development, but knowing that and making a buck from the knowledge are two different talents.

Bears tend to scoff at new era thinking, but cogent arguments can be made for this being a new era, and some of my best friends are new paradigmers. Given current market valuations, however, aggressive investors in today's stock market are consciously or unconsciously betting that this is a new investment era. Predicting new stock market eras is a low probability event, just like predicting stock market crashes.

I like to think of this bet in terms of the work of Blaise Pascal, the 17th century French mathematician. Pascal said that each of us is wittingly or unwittingly making a wager on the existence of a supreme being in the way we live our lives. Pascal suggested focusing on the risks of being wrong. A bet on the existence of a supreme being risks the opportunity cost of the time spent in church or synagogue. If you bet on there not being a supreme being and are wrong, you suffer eternal damnation.

If you bet on a new era and are wrong, there are irretrievable losses without sufficient time to rebuild your nest egg.

Without commenting on the theological efficacy of Pascal's analysis, we believe it provides a framework for thinking about managing client money. Our typical clients are early baby boom professionals investing retirement money or entrepreneurs who just sold their business. If we bet on traditional valuation methods and are wrong, there is an opportunity cost from being a little too conservative in a buoyant market. If we bet on a new era and are wrong, there are irretrievable portfolio losses for people who don't have the time to recreate their nest egg. We are not mutual fund managers who win by taking risks to be at the top of the performance charts -- we win by keeping our clients following an investment blueprint that makes sense for their unique situation. We cannot forget that we are dealing with real lives, where the pain of loss is usually greater than the pleasure of winning. Business school bell curve graphs don't measure the intensity of emotion on the left-hand side of the curve. Joe Louis said "I've been rich and I've been poor, and rich is better." In investing, I'd update that to "I've suffered real principal losses and opportunity cost losses, and opportunity cost losses are better."

We believe that the reason most people don't reach their financial goals is not that they invested in the wrong stock, sector or mutual fund. The biggest barrier is behavior. As Dwight Rose knew in 1928, most investors achieve substantially lower returns than the instruments in which they invest due to their behavior -- getting greedy and buying when the market has gone up and becoming fearful and selling when the market goes down. We also all tend to extrapolate the recent past. We were begging fearful prospects five years ago to move at least some money out of money funds into stock funds. Our typical prospect now is completely invested in aggressive growth stocks and we are trying to talk them down off the ledge.

A big part of our value-added is managing not money but client expectations and emotions. Behavioral issues matter more than whatever Chairman Al had to say in an unguarded moment. Investing mixes the achievement of your goals and risk tolerance with a gaming aspect that is emphasized by both the media and many service providers. Keeping our clients focused on their long run investment objectives means separating them from the destructive gaming instinct. This may make them more boring at cocktail parties or around the water cooler, but we believe it increases their chances of success.

The gaming aspect also encourages people to latch onto investment styles that may be *au courrant* but which are inappropriate for them. We analogize this to dieting -- there are a lot of diets that can make people lose weight, but there are still a lot of obese people around because they cannot stick to the diets. There are a lot of roads to investment success, but if you can't consistently follow the plan, they are worthless. Unfortunately, our brains are naturally wired to make us optimistic at market tops and pessimistic at market bottoms.

It was all there in 1968 -- day trading, tech stock mania, high Dow predictions and firing advisers for "boring" recommendations.

It is almost impossible to overstate the importance of sentiment in driving the markets both above and below the theoretical "value" of the underlying businesses. We were recently reviewing Newsweek and U.S. News and World Report articles from 1968, at the peak of the 1960's bull market. You could change a few details and publish them again today. It's all there -- day trading, tech stock mania, outlandishly high Dow predictions, widows firing their conservative advisers because they keep recommending boring investments, and partners in prestigious Wall Street firms predicting prosperity as far as the eye can see due to the good economy.

In contrast, we also recommend reading a 1979 cover story in Business Week (at Dow 875), "The Death of Equities," in which similarly prestigious pundits announce that stock market investing a vestige of the past. A Salomon Brothers study showed the 10 year average annual rate of return on stocks of 3.1 percent contrasted unfavorably with the 19.4 percent average annual return from gold and the 11.8 percent return on diamonds. Praising a recent ruling allowing pension fund money to be invested in commodity futures, gold and diamonds, the Southern Methodist University's business school dean stated "We have entered a new financial age. The old rules no longer apply."

See, those new paradigms are everywhere, if you only know where to look.

In closing, where are we today? Similar to Dwight Rose's 1928 appraisal, the equity markets have had a substantial tailwind of falling interest rates, disinflation and price/earnings multiple expansion since 1982. If we look at the actual earnings growth in the S&P 500 since 1982 and apply the then-current price/earnings multiples, it would explain an advance in the Dow from the low of 780 to about 2,500. The rest of the advance from 2,500 to where we are today comes from us feeling better about those earnings. We were clearly too depressed in 1982, but shouldn't we also consider the possibility that we are too optimistic now?