The Four Most Expensive Words in History
"This Time It's Different"
September 7, 1999

Summer is officially over on Wall Street. Investment Bankers, traders, and fund managers have returned from the Hamptons (or other suitable locations) to once again ply their trade. Loaded down with stock charts, economic reports, and stock tips garnered from other investment professionals presumably while relaxing on their new sailboat courtesy of the greatest bull market in history, they come ready to face what will be one of the most interesting market environments in recent memory.

The summer itself was rather quiet in retrospect. In fact if you paid attention only on the last day of this season, this past Friday, you would have caught the majority of the action. From Memorial Day until Labor Day the indexes meandered in a range of approximately 4% as investors tried to guess the movement and degree of interest rate hikes. Even with the favorable employment numbers released on Friday, the jury is still out as to what the Federal Reserve will do at both the October and November meetings.

Currently the smart money says at least one more rate hike of 25 basis points by the Fed before the end of the year.

The rise of the markets in the face of continued deterioration of market fundamentals has caused some consternation among rational and sane investors. The breadth of the market, or the number of stocks rising compared to those falling, is currently below those levels experienced last fall when the worst of the panic selling had gripped investors. In fact the majority of stocks on the NYSE have been trading below their 200 day moving average over 80% of the time for the past eighteen months. However, during this period we have seen the markets rebound and move even higher.

This concentration of strength into a small group of stocks does not bode well long-term for the markets.

Negative breadth in a rising market is not new, in fact for two years previous to the 1929 crash, breadth was extremely negative as was also the case in the late 1960s. In both of these instances a small group of stocks continued to lead the indexes higher as the underlying health of the markets continued to worsen. Once these market leaders finally capitulated, their fall was rather significant. In regards to the "Nifty Fifty" in the early 70's, these stocks eventually lost approximately 80% of their value from highs to lows.

This lack of positive breadth in the markets can be clearly seen in the NASDAQ where Microsoft, Intel, and Cisco Systems make up 25% of the indexes value. As these companies have continued to move higher so have the indexes even though the majority of the stocks within the NASDAQ have been falling. The average Price to Earnings of these stocks is now slightly north of 65. Historically P\Es in expensive markets rarely move above 18.

Based upon the I\B\E\S equity valuation models, the market has continued to trade for the past 36 weeks in overvalued territory. Current models now show the market approximately 41% overvalued. The previous *record* was before the 1987 "correction" where the model flashed a 30% overvalued level for about five months. This data now seems to confirm the Feds model in valuing the stock market, which has been displaying similar signs for quite some time.

In light of these historical precedents the markets still continue to move higher. If the markets have continued to march higher for reasons that are not based on fundamental or technical precepts, then there must exist an emotional basis for the markets movement over the short-term.

I recently had the opportunity to spend a quiet afternoon at a local University library. Unlike my college days when I would take these opportunities to catch up on my sleep, I actually went to research some historical aspects of the markets. Specifically I wanted to delve into investor sentiment during two periods, 1927-1929 and 1967-1971. As I am sure you are aware both of these periods preceded rather significant declines in the market. Additionally, in both of these cases investors completely changed their outlook and viewpoint on stocks in general that lasted for several years going forward.

The focus was not on specific news or stock movements, but rather to identify what the investment professionals and individual investors at the time was thinking in regards to the markets. The Wall Street Journal having been published continually during this time frame was my reference source.

There were a number of parallels between these periods and today, but the most fascinating was the opinion repeated in any number of articles and interviews that during each of these times due to technology, global economics, and the proper management of expectations that **This Time It Was Different !**

During the 1920s with the advent of the radio, telephone, and automobile being used on a wide spread scale, investors seem to have felt that productivity would increase indefinitely. Information would be shared on an almost instantaneous basis, with the improvements in transportation all areas of the world would be accessible. For the first time in history investors would experience the benefits of a global economy.

With the dramatic steps being taken in the area of technology, companies such as RCA would be market leaders into the foreseeable future. For this reason, companies of this nature, industry leaders, were afforded Price to Earning ratios well above not only their peer group but also all historical standards. Investing in these companies provided an almost risk-free environment as they held the keys to the future. (Unfortunately if you had bought RCA anywhere near it's high in 1929, you would have had to hold the stock for the next thirty years to break even. This is what is referred to as long-term investing.)

This attitude could be somewhat akin to the feelings directed towards the Internet today and those companies contributing to its development.

In addition during these periods, investors disregarded any fundamental basis in purchasing equities and focused only on what was "hot". It became almost a herd mentality with individuals pouring money into a more concentrated selection of stocks until only a few companies were moving higher strictly on momentum generated by cash flows.

If you doubt that this is a fair comparison with today, ask an investor why he bought a particular stock, what the company does, and at what point and for what reasons would they sell the position.

Finally the most disturbing parallel was the opinion that stocks held no risk for long-term investors.

In the 1920s widows and orphans were told of the benefits of owning stocks. Individual investors plowed their savings into the stock market to buy shares of their favorite companies, many of them on margin. Given that the recent introduction of individual investors participation in the market place would ensure a continuing supply of new cash to sustain stock prices and continual advances in technology would guarantee increases in productivity and profit margins, **stocks could not help but move ever higher**. A similar attitude was repeated in the late 1960s with the Nifty Fifty.

A book was recently written explaining that the DOW Jones Industrial average should trade somewhere in the neighborhood of 25,000 given that long-term, stocks always go up so therefore stocks do not have a risk premium. I don't mind the book so much as the fact that the premise was treated in a credible fashion by investors..

This exercise in comparisons to previous market trends could obviously go on almost indefinitely, or at least into a fairly lengthy book. However, the point I am trying to make is that the markets do not move for indefinite periods in any one direction and a degree of caution is appropriate at these levels of the markets. Rather than focusing only on what has performed well recently, attention should be paid to those areas of the markets that may have gone out of favor.

On the international front Europe and Japan continue to appear to be rebounding and on a valuation basis are more attractive than the U.S. market. Over the next twelve to eighteen months it may well be possible to generate a higher rate of return in a diversified equity portfolio overseas than domestically.

In addition, it is expected that the markets here in the U.S. should experience a pull back, whether it is attributed to Y2K issues or just valuation levels in light of rising interest rates. If portfolios contain significant levels of cash, investors would be well advised to wait for a better entry point into the markets this fall. Given the Pavlov dog syndrome investors now adhere to, a decline of 10 to 15% may be all that the markets could experience before investors rush in once again to bid shares higher.

And finally with the threat of higher interest rates, high-quality shorter maturity bonds would be recommended for those portfolios desiring a reduction in volatility in tandem with a potential income stream. If the economy does experience a slow down and debt loads continue to increase on the corporate side, junk bonds could suffer from a flight to quality and reductions in this asset class would be appropriate.

Synopsis:

There currently exist a number of parallels to previous bull markets that should provide a cautionary note into investor's portfolios. Though the bull market could continue well into next year and the stock market could broaden its breadth, entry points should be carefully considered. Finally, focusing only on the current "hot" stocks could blind investors to better valuations and long-term growth prospects in other areas.

In regards to questions specific to your portfolio and financial position, please contact our office at your convenience to schedule a review. Thank you for your continued confidence.

Very truly yours,

Brad L. J. Griswold