

## **The Fiduciary's Dilemma**

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The fiduciary with responsibility over any institutional investment portfolio is confronted with the most perplexing conundrum of his/her career. Interest rates on long term bonds, at just a bit over 5%, are near their low yields of the past 30 years. Rates on shorter, less volatile fixed income securities are even lower. In an era in which double-digit returns from common stocks have become commonplace, there is little attraction to the fixed income sector. Because historically outsized returns have accrued to common stocks almost every year for more than a decade and a half, most fiduciaries have known no other environment during their periods of responsibility over these institutional assets. On the surface, the investment answer is obvious. Buy stocks and enjoy the ride to ever-higher portfolio values. After all, the long-term statistics all verify the wisdom of that course of action, and the analysts and strategists profiled on TV's business and general news shows urge you toward that path every day. The conundrum arises, however, for fiduciaries that know more than just the financial headlines. To participate in stocks at these market levels requires fiduciaries to pay far more for ownership than at any prior time in U.S. history. And unbroken precedent teaches the fiduciary that even when fervor for overpriced stocks has been far less euphoric than it is today, major losses of portfolio value have preceded any long-term increase. What's a fiduciary to do?

A great many factors shape the environment in which common stocks rise or fall: interest rates in this country and around the world, current business conditions domestically and internationally and investors' outlooks for such conditions in the quarters and years ahead, current corporate profits and their prospects for growth or decline, the current and potential returns on competing non-stock investments, the supply of money being pumped into the system, and the level of investor confidence in the prospects for future stock profits. Some of these factors are currently positive, some negative. Let me summarize the condition of each of these variables.

Interest rates both in the United States and in most of the major industrial countries around the world are very low by the standards of recent decades. Some of the former Asian tiger countries and a number in Latin America that are struggling to defend their currencies are in stark contrast with rates well up into double digits. Slowing business conditions in the U.S. will continue to put downward pressure on domestic interest rates as we head into 1999. A possible wildcard in the U.S. interest rate picture, however, would be the repatriation of capital by Japanese or European investors. Both are holders of very large quantities of U.S. debt in the form of bonds. Should either contingent, either because of the need to shore up Japanese yen-denominated investments or because of a desire to diversify into new Euro-denominated securities, pull substantial funds from U.S. investments, our interest rates could spike upward, driving bond prices down.

U.S. business conditions remain relatively healthy. Fed Chairman Alan Greenspan has warned, however, that it is unlikely that the United States will remain an island of prosperity in an unhealthy international environment. A serious recession still claims most of Asia with only a few glimmers of hope in selected Asian economies. The 500-pound gorilla remains Japan. There are faint signs of a few economic upticks there, but some analysts attribute those to the recent outburst of government spending which cannot be sustained. Japanese banks remain in serious condition with the amount of acknowledged bad loans growing by the week. The Japanese economy has been weak for nearly a decade, and most analysts expect that it is at least a few years away from a significant recovery. In Latin America, Brazil has recently devalued its currency, and there is no certainty that it will not be repeated. Despite the \$41 billion rescue effort being undertaken by the International Monetary Fund, questions still exist about whether Brazil will be able to repay its debts in 1999. As the economic engine of Latin America, continuing economic travail in Brazil would inevitably infect the rest of the region with serious consequences to companies that export there. The Canadian economy remains less than vibrant, and Europe is slowing. In the eighth year of the current business advance, it is questionable whether the U.S. can grow much longer with overall world business slowing. When looking several years down the line it is important to realize that even the most optimistic economists see the U.S. Gross Domestic Product growing significantly less than it did in the earlier decades of this century. That is typical of mature economies. They tend to grow less rapidly than young, emerging economies. This should be a sobering realization to all who ignore history in the belief that the Internet and high speed computing make this an investment environment in the United States unlike all earlier ones. No matter how much innovation occurs in the United States, there is a wide world of eager, sophisticated business people ready and willing to compete away any excess profit advantage that exists here. The U.S. cannot protect such an advantage for long. That is the flip side of instantaneous data transfer and globalization of business. These factors considered, it becomes clear why Chairman Greenspan cautions that we will not long remain an island of prosperity.

U.S. corporate profits have stagnated in 1997 and 1998. After very strong corporate earnings growth from 1992 through 1996, earnings have barely budged since then. Standard and Poor's reported that the growth in earnings in the S&P 500 companies was 2.6% in 1997. They estimate that 1998's final figures will show a decline of 1.5% in S&P 500 earnings. In each of the past two years investment analysts, an inherently optimistic crowd, forecast earnings growth near 20%. That group remains optimistic for 1999 as well, although their enthusiasm has been slightly muted because of the experience of the past two years. In fact, in a recent study Value Line reported that its analysts have made upward revisions of their earnings estimates on 89 of the stocks that they follow and downward revisions on 394. That is the largest disparity since early 1991 when the United States was in recession. In Value Line's 30 years of experience, they have found that revisions in either direction tend to be followed by future adjustments in the same direction. In other words, initial revisions tend to be understated. This bodes ill for the earnings forecasts for 1999. For the time being at least investors are paying scant attention to corporate earnings.

The dividend yield on the stocks in the S&P 500 is 1.3%. If a broader base of stocks were considered, the yield would be even lower. Obviously today's stock investors are not buying primarily to get the dividend. They are counting on substantial capital appreciation to justify their purchases. That expectation has been rewarded like never before over the past decade and a half. Will it continue in the years ahead? Throughout most of this century the average total return on common stock has been about 10% per year. That return has come on average from approximately a 4% dividend and a 6% capital appreciation. The yield on high-grade bonds has generally been in the neighborhood of 150% of common stock dividends, or about 6%. Today, stock dividend yields are so low that high-grade bonds yield over four times the amount of the common stock dividend. In past decades even approaching that disparity between stock and bond yields has led to significant declines in stock prices. Over time investors also compare stock yields with the yields on non-security investments. Real estate has traditionally been a competing asset class to common stocks. Commercial real estate, residential real estate and raw land have all proved more or less attractive in different time periods. With dividend yields so low, virtually any income producing real estate is today offering a greater return than common stocks. The only advantage to stocks in the years immediately ahead would come if their capital gains outstripped the increases in real estate prices. Real estate in most parts of the country is far less overvalued than are common stocks.

The rapid increase in the supply of money is one of the primary causes of the continuation of this great bull market. Perhaps afraid of the disinflationary and deflationary forces apparent around the globe, the Federal Reserve has been pumping money into the system very aggressively over the past year with the rate increasing in the most recent quarter. When such money cannot find a good business purpose, and many companies have pulled back on their capital spending, it often finds its way into stocks and bonds. Because the U.S. has not been experiencing any significant inflation, the Fed has been able to lower interest rates and pump plenty of money into the system. Chairman Greenspan and other members of the Fed's Board of Governors continue, however, to issue warnings about the potential for an increase in inflation. They know that these loose money practices have traditionally led to inflation. Should inflationary trends surface, the Fed would almost certainly tighten the money supply and raise short-term rates. That would be a very difficult environment for common stocks, even if they were not more overvalued than ever before.

The single most important reason for the continuation of this greatest of all U.S. bull markets is the massive levels of confidence that investors have that stock buying presents no long term risk. On the contrary, today's stock buyers, according to recent surveys, believe that they will reap rewards near 20% per year for the next decade or longer. Such levels of confidence are rare in U.S. history and have only occurred after many years of almost uninterrupted stock market gains. In the past, such levels of enthusiasm for stocks, never as great as today's, have marked market peaks, not periods preceding continuing market advances. Such periods have also been characterized by dramatic excesses and the belief that such behavior was not really excessive. Today we have the example of the Internet stocks, which have clearly become a bubble sector. Prices have been pushed way beyond the realm of reality. For example, America Online has a market capitalization of about \$80 billion with 1998 earnings of \$230 million. Amazon.com, the

online bookseller, which may or may not ever make any money, reached a market capitalization just a few weeks ago of over \$30 billion. That's worth more than the country of Norway. Yahoo, with a market capitalization a few weeks ago of \$44 billion and 1998 earnings of about \$45 million, is worth more than all the stocks on the Singapore stock exchange. These companies and others in the same industry have all been founded in the past several years. The industry's technology is evolving, and no one knows what the industry will look like five years from now, much less over the long term. Very likely the leaders of this industry ten years from now are not even on our radar screens yet. Many of today's hottest companies will likely never make a profit and will fade from the scene in the years ahead. That notwithstanding, nearly \$250 billion of investor money is in these stocks today. It is pure speculation that many professionals are masquerading as investment.

Some argue that while they don't know which Internet companies will be the long-term leaders, it is prudent to participate in the group even at these extreme prices because it is the wave of the future. That echoes the claims of decades past about stocks in a variety of emerging industries. In the late 19<sup>th</sup> century, investors thought they had a sure thing with the advent of electricity. We hear talk about the Internet as a reason for looking at this as a new era justifying new investment principles and standards. Imagine how much more dramatically people's lives were changed by the widespread introduction of electricity. Most of the advances of the twentieth century were made possible through the use of electricity. At different times the spread of rail transportation and the advent of automobile and air transportation shrunk the size of our country and our globe, facilitating the movement of people and goods. The development of telephone technology and the spread of its use fostered instant communication across the globe. The developments in medicine and biotechnology lengthened lifetimes and the quality of life. The invention of the computer and the development of its technology have changed the face of business, the pace of knowledge development, and in many respects our ways of life. Each in its own time was a reason offered by optimistic investors as justification for looking upon that period as a new era making outmoded past market and economic principles. Amazingly, the time-tested measures of value have survived these and all other societal changes of lesser magnitude over the past century. That unwavering consistency should lead any good student of market history to look askance at the new era claim that "It's different this time." That becomes an even more obvious conclusion when we realize that the screaming overvaluations in the U.S. stock market in January 1999 are not mirrored very widely. Severe overvaluation is, for the mostpart, limited to a relatively small number of western stock markets. Formerly dramatically overvalued Asian and Latin stock markets have been smashed to fractions of their former highs. Real estate in the United States and elsewhere around the world, which exhibited extreme valuations in some areas, was severely cut in price from the extremes. At different times and in different sectors various types of art and other collectibles have seen the bottom fall out of their markets. A few western stock markets are among the relatively few areas that have so far resisted revaluations to more historically normal levels. Despite the near reverence in which are held Alan Greenspan and his fellow Federal Reserve governors, U.S. investors have disregarded their repeated warnings of "irrational exuberance" and insufficient earnings to justify today's stock prices. Investors are basically disregarding anything that could disrupt the party.

It is important to recognize what stock buyers are paying today. The S&P 500 is selling at about 33 times its 1998 earnings. Since its beginning, that index has sold on average at just over 14 times its earnings. The S&P 500 is selling at more than 75 times the dividends being paid out by those 500 companies. Historically the stocks in the index have sold at about 26 times what they have paid out. The industrial stocks in the S&P are now selling at over 5 ½ times their book values. Over the past 71 years those stocks have sold on average at 1.9 times their book values. Throughout this century stocks have routinely sold above and below their long-term average valuations, although never more above than they are today. Invariably they have reverted to their long-term mean levels of valuation. Almost certainly they will again, whether quickly or in the years ahead. If the Dow Jones Industrial Average instantly reverted to its normal valuation levels, it would have to fall into a range between about 3100 to 4100. From 9200, where it rests today, a decline to that range would necessitate losses ranging from 55% to 66%. Many today see such a decline as inconceivable. In the United States we have only three instances in this century in which investor sentiment has even approached today's unprecedented euphoria for stocks: in the late 1920's, the late 1930's and the late 1960's. The ultimate price declines from the market highs that accompanied these peaks of investor sentiment were 89%, 52% and 45% respectively. More recently the runaway Japanese stock market that peaked in the late 1980's reached a low last year 67% below its high of nearly a decade earlier. We have not one precedent in any major industrial country's 20<sup>th</sup> century stock market history of a severely overvalued market avoiding a major loss (usually over a period of several years) before ultimately advancing on a more sustainable basis. Perhaps even more disheartening, the recovery periods to the former high prices have been discouragingly long, 25, 12 and 16 years respectively in the United States. It has been over nine years since the most recent peak in the Japanese market, and Japanese stock prices are still 63% below those former highs.

Many of today's investors anticipate that they would simply ride out any decline. They profess a long-term orientation, and many see any decline as an opportunity to buy more stocks. If markets continue up in future decades as they have in the past, that is a sound plan. Unfortunately, even the soundest plans can be confounded by highly fallible human beings. By way of most recent example, fiduciaries should review the responses of their board members after the brief but sharp market crash in 1987. Many fiduciaries were very reluctant to recommit money to stocks after stock prices fell 36% in less than two months in late 1987. That is consistent with what fiduciaries have done after every sharp market decline, especially when the price decline has taken over a year or more. The tendency to avoid stocks becomes stronger the longer a decline lasts. From personal experience I can vouch for the difficulty of convincing fiduciaries to commit significant portions of portfolios to common stocks after the markets have been non-productive for years. For the entire decade from the mid 1970's to the mid 1980's, the price to earnings ratio on the S&P 500 ranged from about seven to thirteen times earnings compared to today's 33 ratio. Despite stocks selling at extremely cheap prices for an entire decade, almost nobody wanted to own them. Of course, investors who accumulated large amounts of cheap stock while it was on the bargain table ultimately reaped high rewards when those stocks eventually reverted to and beyond historically normal higher valuations. Unlike the behavior of potential investors in that decade of ultra cheap stock prices, today's investors can't get enough stock despite the fact that it is more expensive than at any prior time in U.S. history. Before the decade of the 1990's, investors who

purchased stock at below normal valuation levels have always had significant profits five and ten years later. Conversely, investors who have purchased stock near overvaluation extremes have always shown net losses five and ten years later.

For all their long-term predictive properties, valuation measures are not precise short-term forecasters. Investor sentiment can carry a market from one extreme to an even greater one, especially if augmented by infusions of additional liquidity. The market's behavior in the past quarter is an excellent example of that. When cumulative world problems led the market to its early October lows, the Federal Reserve came to the rescue with three cuts in short-term interest rates, and they revved up the money supply. That rekindled investor enthusiasm to recent unprecedented heights. The world's financial problems have not disappeared, however, and corporate earnings are now slowing or declining in most of the world. While the Federal Reserve could still reduce rates again, pressures could arise in 1999 that might lead to a Fed tightening.

A very important short-term consideration is the technical condition of the market. While the major stock averages are currently at or near their all time highs, they have been led there by a disproportionately small number of companies. Because the S&P 500 and the NASDAQ are capitalization-weighted indexes, the price performance of the largest companies is far more important than the price performance of average sized companies. In 1998 the S&P 500 was up 28.6%, despite the fact that roughly two-thirds of the stocks showed a loss for the year and the average stock declined by 4% in 1998. The index showed such dramatic gains while most stocks were down because of the spectacular performance of large stocks such as Dell Computer (+248%), EMC Corp (+210%), Lucent Technologies (+175%), Ascend Communications (+168%), and Cisco Systems (+150%). With Price/Earnings ratios of 97,78,60,75 and 80 respectively, these stocks were obviously the provinces of traders and longer-term buyers willing to suspend belief in the need for visible earnings. No value stock buyers true to a value orientation (like Marathon) could touch stocks at valuations like that. In such an environment growth stock managers will certainly outperform value managers who stay true to their time-tested disciplines. It is instructive to note that growth stock managers always outperform value managers in the periods just before major market tops. It is also important to recognize that the vast bulk of the pioneer leaders in the industries discussed earlier as society changers in the past century (electricity, railroads, automobiles, air transport, telephones, biotechnology and computer technology) either went out of business or suffered major stock price collapses after the period of initial euphoria. That fate may befall most or all of today's Internet leaders. Apropos of 1998's market leaders, which are all in the high tech sector, it is important to know what has happened to the high tech market leaders of the past. Twice before, from the late 1960's to the early 1970's then again in the early to mid 1980's, computer technology grabbed the investing public's attention, and the prices of these stocks skyrocketed. In a fascinating study of the leading two to three dozen firms from those eras, Marc Faber published results in Barron's that showed the average loss of the leading tech stocks to be about 85% from their highs to their lows in each era. While the growth stock tech jockeys are riding high right now, they will almost certainly experience the down side of the roller coaster in the quarters somewhere ahead. Such declines have been gut wrenching in past bear markets.

While trying to make short-term market calls is a perilous business, there are ominous signs today. It is rare that major investment indexes rise very long once the majority of stocks start to decline. While the market averages are currently near their highs, more stocks have declined than have risen since April 1998. That is a pattern that has preceded most stock market peaks throughout history. The analogy Wall Street has used for decades for this condition is that of the generals leading and the troops not following. It is considered an ominous condition usually masked by the highly favorable publicity accorded the market leaders. That is exactly what the market is experiencing today.

This brings us back to the fiduciary's dilemma. Should (s)he either stay committed or become more committed to common stocks which have been an unrelenting engine of asset growth virtually without interruption for more than a decade and a half? Or, conversely, should the fiduciary keep minimal exposure to common stocks in recognition that in no major stock market in this century have common stocks reached levels even close to current valuations without suffering serious losses, some of which have lasted for a decade or more? If the latter choice is made and the markets continue to climb in the year ahead, there will be inevitable regret that opportunity for profit will have been foregone. If fiduciaries choose the former course, which is the advice of the majority of today's market analysts, and the markets ultimately do what they have always done, the portfolio will experience significant losses that may not be recovered for years. An even bigger danger would be that current or successor fiduciaries might lessen the exposure to common stocks after major losses, which is what fiduciaries have done after every major market decline in this century, thereby fully realizing the losses and lessening the potential for future recovery. The lesson of history is clear, but throughout history the majority of fiduciaries have consistently chosen to follow more popular current sentiment, rejecting historic precedent. At every major market top and bottom throughout the century, however, following the popular belief proved wrong and historical precedent reasserted itself. It does create quite a conundrum.

We remain ready to add to common stock holdings when prices retreat toward more historically normal levels of valuation. We will miss most of the froth and excitement near the market highs, but, conversely, we expect to miss most of the pain that markets traditionally inflict when they fall to their mean valuation levels. In the long run remaining faithful to the time tested standards of value has led to better results than chasing the more exciting and currently more popular "growth at virtually any price" approach.

Thomas J. Feeney