

2000 A Bubble? 2002 A Panic? Maybe Nothing?

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Does this September *New York Times* headline “The Bubble Has Burst, But Strengths Remain” seem all too familiar these days? Given what we have learned over the last two years, the late 1990's presents a painful lesson. If you have learned that lesson well, then I have an easy question for you to answer. Was the 1929 stock market peak a bubble, or was the crash that followed a panic? Now this should be easy. After all, you identified the 2000 market peak as a bubble and you only have two years of data to work with. Compared to the 73 years of information generated since 1929 that is nothing.

How about some more recent price moves? Was the 1969-1972 run up of 40% a bubble, or the subsequent 46% fall from 1972-1974 a panic? Then there was 1987. Was the price rise of 32% during the first nine months of that year a bubble, or the October crash of 26% a panic? Why does it seem so much more difficult to classify events in the “distant” past for which we now have so much more data regarding subsequent stock returns, especially when compared with 2000?

Maybe the problem lies with our current shortsighted 20-20 hindsight? Typically, people think of “bubbles” as having occurred if the market goes up and then falls by a large amount. By that standard, it does appear 1929, 1972, 1987, and 2000 were bubbles. But, what about panics? A panic is generally thought to have taken place if stock prices dive and then rebound. By that standard the crash of 1929 was a panic. An investor buying at the peak and holding until today

would have earned a compounded return of about 9.7% per year. Compare this with investing in something safe like treasury bonds which to date have only returned an average of 3.5% per year. The more recent “bubbles” of 1972 and 1987 present similar problems. If you purchased stocks at the 1972 peak you earned 10.3% per annum to date, while bonds have returned only 6.4%. Even for the relatively recent crash of 1987 the score to date is stocks 8.8%, bonds 5.0% per year.

Of course, the 2000 market peak is different. Everybody saw it coming. Professor Robert Shiller’s book *Irrational Exuberance* made the best seller lists in 2000. Certainly many were listening. Then, of course, there were newspaper headlines like the *Wall Street Journal*’s, “Industrials Leap 47.63 to Another High --- Three Measures Indicate Stocks Are High Priced.” Money managers issued warnings too. Richard Fontaine had \$400 million in assets when he stated, “We’re in an extremely dangerous situation that can only be corrected in one of two ways - either by a tremendous spurt in the economy or by a big drop in stocks. And I don’t see any big earnings spurt . . .” Prescient warnings to a deaf investing public? That all depends on whether you take into account that the headline comes from an April 1992 article, and the quote from early September of that year. If you ignored their counsel, purchased stocks and held them until today you earned a compounded annual return of about 8.5%. Not bad.

Even today you can find those predicting a stock market revival, a further decline, or anything in between. For example, a *New York Times* article from October 14 of this year quotes Jeffrey Kleintop, chief investment strategist at PNC Advisors as forecasting, “a 40% gain for the S&P 500 by the end of next year.” But the same article also attributes to Lowry’s Reports’ Paul Desmond the view that “although the market may be near [a bottom] now, it isn’t there yet,” and to FleetBoston Financial’s Keith Banks as saying that “It will be a choppy market without a noticeable uptrend for a while here.” While I have no idea who will be right, I can guarantee you

that one of them will be. Yes, the market will be either up, down, or flat. I can also say with some certainty that whoever is right will be quoted yet again in some article about the market's future.

But, the fact of the matter is that if you spend a little bit of time searching you can always find headlines, and individuals predicting the next market crash. Just as you can find those predicting a boom. Thus, after any crash or boom somebody will have been right. The problem is how do you know who to listen to *before* a big move in the market? History offers very little guidance. Large run ups are not always followed by large declines. Suppose you only invested money in the market the year *after* it went up by 33% or more. On average you would have earned 13.7% the following year with a strategy that would otherwise appear to give new meaning to the term "irrational exuberance."

Still, some argue that 2000 was a bubble because valuations were so out of line with fundamentals. For example, as the *Wall Street Journal* warned, "By three time-tested measures -- earnings, dividends, and book value -- stocks are at optimistic, and in some cases unprecedented, valuations. . . Never before has the S&P's price/earnings ratio risen so high, not even in the great bull-market peaks of 1929 or 1987." Trouble is, the warning came in April of 1992. Not to be outdone, in 1993 the *Economist* quoted Professor Josef Lakonishok (who now co-owns LSV Asset Management with \$8 billion under management) whose study ". . . found that total returns (capital growth plus dividends) were low after months in which p/e ratios were high." No doubt, in 2000 price-earnings ratios did reach an all time high. However, as the 1992 quote shows that is not at all unusual.

One reason price-earnings ratios say so little is that they have been drifting up over time. For example, investing in the market only when its P/E ratio lies below its historical mean keeps

your money out of stocks since the beginning of 1986. To put this into a longer perspective, this same investment rule only has you in the stock market during 19 of the last 77 years. But are those the “right” 19 years? Not at all. Since 1925 your compounded annual return has come to only 3.3%. Other “reasonable” strategies that revolve around the P/E ratio produce similar results. For example, if you only invested when the P/E ratio was below its 10-year moving average you would have a compounded return of only 4.2% to date.

Given how poorly the P/E ratio has fared as a guide for making investment decisions, why has so much attention been devoted to it? I suspect, the answer is simply because it seems like it “should” work. After all, what can be more sensible than buying stocks when you can acquire their earnings at a low cost, and sell them when they are expensive. But the problem is that the P/E ratio looks at historical earnings, and the market is not about the past but the future.

Telling you last year’s corporate earnings may or may not tell you a lot about next year’s earnings, or almost as importantly earnings five and more years out. Yet, such future earnings determine whether or not buying stocks today will or will not produce an acceptable return. Market prices today reflect our collective wisdom regarding future, not past, earnings. For example, at the end of 1973 the P/E ratio was a mere 13.5, lower than it had been in years. But, over the next year the market would drop almost 28%! How did this happen? The P/E ratio was low because investors thought future earnings looked poor. The economy was in the early stages of what would become known as “stagflation,” high inflation with low growth. Apparently though, the market did not fully anticipate just how bleak things would become, and thus dropped further as the bad news mounted. Absent a time machine, it is not clear how anybody in 1973 could have predicted how badly the economy would perform over much of the next decade.

When trying to decide whether or not the market is over or underpriced most people find

that they lack the requisite ability to foretell the future. Worse yet, small changes in the market's forecasts can produce huge changes in stock prices. For example, will long run earnings grow at 4% or 2%? While that difference may not look like much it can easily produce a market swing of 30% or more. Worse yet, how sure are you that the right answer is not 5% or 1%? Today's stock prices constitutes a bet regarding future earnings, from now until forever. But the fact that all future earnings matter makes stock pricing a very uncertain business.

The difficulty with declarations claiming that large stock price moves are “bubbles” or “panics” is that they rely on perfect hindsight, typically generated only a few months or a year following the event. But investors do not have that luxury. They must price securities based on the information they have at the time they make their decisions. If we all knew the market was overvalued in 2000 it would have never reached its peak levels. The fact of the matter is there were reasonable arguments to justify the index levels. Just as there were good arguments for their levels in 1992, 1993, and 1994. Back then there was talk about how the Federal Reserve had become so adept at managing the economy that what had previously seemed like unsustainable growth rates might become the norm. As recently as 1986 Professor Lawrence Summers (now president of Harvard) talked about unemployment rates of 6% or higher as being “normal” for the economy and difficult to reduce below that level without sparking inflation. Today editors bemoan the currently unacceptably high unemployment rate of 5.6%. It is a new world, only we are not quite sure just how new and for how long.

So, back to the original question, was 1929's peak a bubble or its crash a panic? Maybe neither. Going into 1929 the economy had been doing well for a decade and continued to grow at a very good rate. There was every reason to believe that the United States was entering a new era of industrial production. But, back then we did not really understand how the macro

economy works, and government policies were thus often counterproductive. It was reasonable for investors to worry that any small slip in the economy might trigger a depression (a not terribly unusual state of affairs back then), and such pessimism was born out. But who was “more right” the pessimists or the optimists? As it turns out the optimists, but it took about 20 years to find out.

So, how about 2000? The fact of the matter is we will not know if the peak was a bubble, or the subsequent crash a panic for quite some time. That, however, has not stopped the pundits from declaring 2000 a bubble, and the current valuations “realistic.” But, the economy has also changed quite a bit from 2000. Back then, companies were continuing a decade plus long expansion. Profits were rising at an incredible clip, and had been doing so for an unprecedented length of time. Earlier some pundits had declared prices “unsustainable” in 1992, 1993, 1994, and on and on. Even at today’s levels all but those crying out after 1997 have yet to be proven right. At the moment the economy is quite different and it is not at all clear what the future holds.

Will we go back to the “roaring” ‘90's or, the no growth ‘70's. Unless your crystal ball has the answer you will not know if 2000 was a market bubble, or today’s valuations a panic for at least another ten years. That, of course, may also mean that we have witnessed neither a bubble, nor a panic. Prices can never do more than reflect the market’s best guess about corporate America’s future given the currently available information, and long term guesses are notoriously inaccurate. There has been one significant exception. Allegedly, at the turn of the last century J.P. Morgan was asked "What will the stock market do?," and he replied "It will fluctuate." If you keep this in mind, then those welcoming the new era after each boom, and those condemning the market bubble after each bust will seem less enlightened.