Sigma Investment Counselors

Sigma Summaries

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Back to Reality?

The signs were all there. "Momentum" investing, buying only shares of companies that are going up, had become all the rage with even some seasoned pros abandoning their valuation disciplines and defecting to the "growth at any price" party. CNBC featured stories about the double and triple digit returns achieved by teenagers in their "weekly" stock market derbies. And instant wealth was created by investors who bid up the prices of any "dot-com" start-up on its first day of trading as a publicly traded company to levels that had no association to economic value.

The outcome was inevitable. On April 4, 2000 both the Dow Jones Industrial Average and the Nasdaq plummeted more than 500 points. Thousands of margin calls went out around the country. Novice investors who had made substantial wealth in a few months saw their paper profits disappear in the course of a few hours. Many seasoned investors were not unscathed from this major market shakeout either. From March 10, the day the tech-heavy Nasdaq peaked at 5,049, through May 23, when that index bottomed, it fell 37%. Even more jarring, the Philadelphia Stock Exchange Internet Index plunged 43% during the same period.

What appears to have happened was a massive shift in investor psychology away from "speculating" in companies with nifty e-retail and e-commerce ideas, but little else, back to companies with real products, real revenues and real profits. Investors appeared to have awakened to the reality that few of the new technology and Internet ventures will be successful if past yardsticks are a guide. This type of mania is nothing new. People have always been susceptible to speculative fevers.

In 1841, Charles MacKay wrote "Memoirs of Extraordinary Popular Delusions and the Madness of Crowds". The object was to collect some unbelievable instances of speculation and show how easily the masses were led astray. One of the chapters is entitled "Tulipomania", which details the rage for Tulip bulbs among the Dutch in the 17th century, with people of all economic levels converting their property into cash and investing it in these flowers. Foreigners, smitten with the same frenzy, poured money into Holland from all directions. Trading became so extensive and so intricate in these bulbs that a code of laws was drawn up for the guidance of dealers. At last, however, the more prudent began to see that this folly could not last forever. People no longer bought the flowers to keep them in their gardens but to sell them for profit. As more sellers than buyers entered the marketplace, prices fell precipitously, never to rise again. Hence, the term Tulipomania emerged to characterize periods of speculative bubbles.

In more recent years, we can learn from the "go-go" years in the 60s when "sizzle" stocks or concept stocks were sensational performers, or from the speculative excesses in oil and gold shares in the 1979-80 period or the biotechnology boom in the early 90s. And while the businesses may have been legitimate in each of these situations, the Darwinian outcome is that only the strongest will survive. There's little doubt that the Internet, in one form or another, is here to stay. What remains to be seen is which companies will survive their frenzied births. In the interim, manias inevitably collapse and the shakeout period to determine the few long-term survivors begins its course.

While Sigma portfolios as a whole fared relatively well during the Nasdaq tech stock slaughter, not every stock in Sigma's portfolios escaped the spring correction. Despite this, Sigma welcomes more rational stock prices. The outlook for the markets longer term should be safer and less volatile.

Correction of market excesses also will be healthier for the economy as a whole. When the market accords businesses extraordinary valuations, the whole economy is impacted. For instance, profitable, growing non-tech businesses have been crowded out from raising capital by potentially fast growing but not yet profitable internet ventures. In addition, the labor markets have been squeezed by graduates seeking dot-com employment or by individuals leaving full time employment to become get-rich-quick "day traders." To the extent the excesses in the recent stock market pullback have been tempered, the negative impact on capital formation and the quality of our workforce also may have been assuaged.

At Sigma, however, we have another concern that even the recent stock market decline may not have completely remedied – that is, a continuation in high investor expectations. We are aware of shareholders in 1999 who were disappointed that their investments for the year had not appreciated by 30-50%. And recently we have heard some investors, apparently undaunted by the recent stock market slide, assume that equity returns will average 20% annually for the foreseeable future.

Since 1926, common stocks as measured by the S & P 500 index have returned an average of 11.35% per year through 1999, according to Ibbotson Associates, a research firm based in Chicago. And that number has been skewed upward by above average market strength in recent years.

In 1999, the S & P 500 gained more than 20% for the fifth consecutive year. There has been only one instance when the S & P 500 index declined for the year since 1980 and the average annual return for the index since then has been 17.98%. We used to advise investors that they could expect investments to be up every two out of three years, not <u>every</u> year. In addition, the S & P 500, the Dow Jones Industrial Average, and the Nasdaq Composite all finished the 1990s at record levels. Furthermore, the technology-heavy Nasdaq Composite was up an astounding record 86% in 1999. The Dow Jones Industrial Average set the previous record for a major American equity index in 1915, when the 12-stock index gained 73%. It's no wonder, therefore, that expectations have skyrocketed.

A large part of the returns that have been achieved over the last 18 years reflect a change in valuations. In 1982, the S & P 500 market index traded at a level that was equal to 8 times its earnings. Based on forecasted 2000 earnings estimates, the multiple currently is 26 times earnings. Some would argue that since we are now in a faster growing economy with lower inflation and interest rates that we should expect earnings to be capitalized at a higher rate. We would not argue with that premise. Our point is that higher valuations already reflect the stronger economic and more benign inflationary environment. As a result the benefits to higher returns from changes in valuations have already occurred.

Does this make us bearish about long-term market prospects? Not necessarily. It just means that returns may be more a function of earnings growth than valuation going forward. And since the long-term earnings growth of the S&P 500 is estimated in the 10 to 12 percent range, it appears unlikely that the market can continue to boast returns similar to the returns over the past five years with valuations remaining constant or declining.

At Sigma, our mission remains the same. We seek to build a diversified portfolio of companies with the most sustainable, competitive advantages in their respective industries using our valuation discipline to reduce price risk. While we are optimistic about the outlook of our domestic and world economies, we caution investors about having too high of expectations regarding the returns of the equity markets, both short and long term. Perhaps this recent sell-off has been just the tonic we needed to help us return to reality.

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