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INVESTMENT POLICY MEMO

The distinguishing characteristic of a bubble in financial markets is that, like its soap bubble counterpart, it bursts leaving behind a meager and ephemeral residue. In the case of soap bubbles our hopes sometimes soar momentarily and irrationally when a particular bubble goes farther, rises higher and last longer than its contemporaries. At the moment all of the considerable forces of what John Kenneth Galbraith called the Conventional Wisdom are mobilized in favor of this analogy for the current stock market.

Indeed it is now almost three and one-half years since Alan Greenspan observed that the market was characterized by “irrational exuberance” and since that time the Dow Jones and S&P 500 stock averages have doubled. During most of that time the *Wall Street Journal*, *Barron’s* and numerous other publications have preached to their readers with innumerable stories and Op Ed pieces about manias, previous crashes, the inevitably bad consequences of prices this high relative to earnings and so on and on. Innumerable luminaries, especially Wall Street professionals, have let it be known that they know this is a first class bubble, and in some cases that they personally have taken all their money out of the stock market.

Soap bubbles may be identifiable by a variety of signs; but the only sure indicator of a financial bubble is that it bursts. So far this “bubble” is intact. How can we explain the remarkable longevity of this “irrational exuberance”? According to the Conventional Wisdom Jane and John Q. Public are to blame. They are infatuated with online trading. They have not experienced a serious loss in 13 years or they have never experienced a serious loss. They are making a lot of money because they don’t understand the dangerous risks they are taking. They have no idea how to properly evaluate stocks and as a consequence they pay fanciful and inflated prices. Woe to the world when they reap the bitter harvest of what they have sown.

Jane and John have long been reviled for their ignorance of investment value. But this contempt is at odds with the evidence. It is a well-known and repeatedly verified fact that most professional investment managers do worse than throwing darts at the stock pages. If the pros do worse than average it follows that Jane and John do better. Federal Reserve flow of funds data indicate that American households have generally unloaded stock to the professionals when the future returns were going to be poor and increased ownership when the future returns were going to be good. In recent years while Wall Street professionals have been bemoaning the excessively high level of stock prices, Jane and John have been making a bundle.

The seminal event for the new stock market era was the crash of October, 1987. Different audiences interpreted this event in radically different ways. To Jane and John the lesson was quite simple. The best time to buy was immediately after the crash. Even if one had bought the S&P 500 at the previous peak price on August 25, 1987, returns over the next five years were still quite respectable at over 7%, and returns for the next ten years were above the

long term stock market average at more than 13% a year. For economists the lessons were dramatically different. If markets were “rational” how could the value of all the corporations in America have declined by more than 20% on a single day (October 19, 1987) when there was no significant news? This disturbing question caused economists to rediscover the obvious fact that securities markets are not consistently rational places. John Maynard Keynes had already written a definitive chapter on this subject more than 50 years before. Keynes observed that figuring out what other investors are going to think a moment from now is less difficult and more remunerative than trying to figure out what a company will earn in the distant future. He also observed that markets, especially investment markets, are dominated by fluctuations in the “animal spirits” of their participants.

In addition to the generally overlooked perspicacity of Jane and John there are other data that challenge the Conventional Wisdom. Some of the apparent extremes in the valuation of stocks are mostly the result of trends underway for over a century rather than a mania of the moment. (The level of the S&P index relative to earnings and dividends at the stock market peak of 1929 was frequently equaled in the 1960’s, ‘70’s and ‘80’s, and defined the low end of market fluctuations in the 1990’s.) Today’s extremely high valuations are concentrated in a very small and narrow group of “new economy” stocks. The typical stock declined by about 20% from April of 1998 to early March of this year. Many indices that are weighted by total market value were unchanged over those two years, including the Russell 2000 and the New York Stock Exchange Composite.

In early March the median ratio of price to earnings was 12.7 for 1,700 stocks followed by Value Line. By comparison the ratio was 19.7 in the spring of 1998 and 10.6 after the crash of 1987. As of today Value Line estimates total return on the median stock will be about 20% a year for the next three to five years. In sum, it is not so clear that most stocks are wildly overvalued. If this is a stock market bubble it will be the first one in history that was so widely identified as such *before* it burst.

At the same time it is hard to believe that the speculative enthusiasm for all kinds of Internet stocks will end up anyway but badly. Hundreds of stocks that have never earned a profit have recently been offered to an enthusiastic public. Many hundreds more new economy stocks sell at unprecedented high prices relative to their earnings. Just 13 of the largest have a combined stock market value over two and one-quarter *trillion* dollars. This is about one sixth the value of the stock of every corporation in America. Yet these companies had combined profits last year of 16 billion dollars or about 3% of all corporate profits. A well-heeled investor who purchased all of the common stock of General Motors, Proctor & Gamble and SBC Telecommunications (the largest local phone company in the U.S.) would pay \$312 *billion* dollars at today’s prices and would have earned exactly the same \$16 billion in profits last year. Although they earned the same 3% of all profits these three companies sell for only about 2% of the value of all stocks compared to 16% for the new economy 13.

This discrepancy in valuations will not persist indefinitely. Indeed it has been closing quite rapidly from even wider levels just a month ago. One aspect of this convergence is particularly noteworthy. The dramatic fall in the new economy stocks has not triggered a lesser fall in the rest of the stock market. Rather other stocks have stood still or in many cases

(including the three companies just mentioned) they have gone up while the Internet related stocks have come down. More generally previous falls in the high-technology, high-flying sectors have not infected the rest of the stock market or the economy. Each fall and rebound is characterized by a shift of interest from one sector of the new economy to another – say from Internet access providers to content providers or from cable infrastructure to fiber optic infrastructure.

In the same way the Dutch tulip bubble was characterized by recurrent fads for one or another shape or color. The analogy is more apt than current enthusiastic speculators would like to admit. The fallacy of the tulip bubble was that varieties of tulips can be naturally reproduced however uncertain the process. The folly of the new economy bubble is that every variety of Internet firm can be reproduced by robust competition. The most wildly overvalued stocks may add up to 25% of the value of the stock market. All technology, telecommunications and Internet-related stocks comprise 30% to 40% of the value of all stocks. If the value of the foolishly overvalued stocks were to disappear in a flash the value of all stocks would be back where it was about 16 months ago. If the remaining new economy stocks lost half of their value at the same time, stock market wealth would be about where it was 18 months ago. These declines would be more comparable to the crash of 1987 in their extent and their small effects than to the enormous size and impact of the bursting tulip bubble in 17th century Holland. Alternatively, the mania could go on for quite a while longer until the market values of new economy companies truly dominated the economy.

For now, the idea that a global stock market bubble is about to collapse with devastating consequences for the global economy seems far-fetched. There are thousands of stocks priced to provide very attractive returns including some in the new technology areas. In contrast, the prospective earnings from holding bonds or cash seem quite modest. What makes the most sense continues to be investing in companies with a highly assured ability to grow their earnings at an above average rate, which also sell at reasonable prices. Such companies are typically little affected by economic recession. I still think that now is an especially good time to emphasize this kind of immunity from cyclical fluctuations. And, even if the apocalypse is not imminent, the unusual volatility and valuation disparities in financial markets suggest that it might prove useful to maintain some reserves in cash or other securities with little prospect of changing value.