

Gut Check: Is It Irrational Pessimism or Time to Go Eat Worms

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Who wants to read a newspaper or watch the evening news any more? It seems every day brings a host of bad news or non-news couched as bad news.

First it's terrorism. Then it's accounting scandals. Now it's accusations that corporate executives and the highest government officials have done unseemly and dastardly things to make a buck.

A Mirror Image?

Way back in the late 1990's, when "experts" were actually saying that huge gains in the stock market didn't have to end, Alan Greenspan warned about "irrational exuberance". His warning was sloughed off at the time. What he was saying is that emotional investing that ignores fundamental economic realities is dangerous, both to the investors and the economy.

In many ways today's conditions look like a mirror image of the late 1990's. Now people are wondering if the stock market will ever make money again. They are as depressed right now as they were euphoric in early 2000.

Reality in the News

To be sure, there are some very negative aspects to the current situation that are both true and worthy of our attention. The accounting scandals and the practices of many at the high ends of corporate America have undermined trust and cast doubt on the veracity of the health of companies. This is very serious.

However, there are also many more executives and companies doing business with honesty and integrity. The media, in its never-ending quest to sell its own products, plays to the negative and makes it seem worse than it is. One must remember that the media itself is mired in its own conflicts of interest and has not been held as accountable for its practices as it should be.

Much Ado About Nothing

No greater example of nay-saying political pandering is the issue of President Bush's sale of stock some twelve years ago. The facts are simple. George, at the suggestion of some advisors, decided to sell stock he owned in a corporation. Because he was considered an "insider" by securities regulations, he was required to give advance public notice of his intent to sell. He then had to wait a couple weeks before he could make his trade.

The President dutifully and correctly filed this notice, which gave anyone who cared to know the chance to evaluate this information and sell his or her shares before George could sell his. This is both fair and appropriate.

So what's the fuss? Somewhere in the process, George's advisors or the treasurer of the company, and therefore, George himself, failed to file a form that simply verified that he made the sale that he and already told the world he was going to do. His

egregious sin here is that a virtually meaningless piece of paper was not filed properly. That is the whole story. There was nothing dishonest or illegal here.

I have sympathy for George, since I was once late with an SEC filing, and though I wasn't lying, cheating or stealing, I paid a heavy price when the SEC spent tens of thousands of tax-payer dollars and countless hours of my time and my staff's time going over every aspect of our operations and making sure we complied with all their myriad regulations. To be sure, some of this was appropriate and even helpful, but the majority was an example of form over substance. While Enron and Global Crossing and others were deceiving the government and the public, we were virtually inundated with detail after detail of regulatory paper pushing, a majority of which was of little real benefit or interest to our shareholders. We did nothing criminal or unethical or self-serving or damaging to our shareholders, yet we were singled out for a lot of attention. From my perspective, it is like watching an officer give me parking ticket while a block away the jewelry store is being robbed. The parking ticket is deserved, but how important is it next to the theft down the street?

Reality in Washington

The reality is that most Washington "insiders" are also insiders in the corporate world. The attacks on the President must be seen in light of politics. For instance, more than 50% of the political contributions of Enron and other companies in the current scandals went to the Democratic Party, yet the democrats want to paint this as a Republican scandal. Yet, as I understand it, the head of the Democratic National Committee made a fortune through his investment in the now bankrupt Global Crossing, the CEO of which was his close friend. Other high-ranking Democrats have similar dealings.

Richard Cheney made a fortune as a CEO. The Bushes made a fortune in their business dealings. Al Gore inherited a fortune gleaned from ownership in companies, including tobacco companies. Whether Republican or Democrat, hypocrisy runs deep in Washington. Few of them are middle class, much less poor. Most of them made their millions not by what they knew but by who they knew. That is not wrong or illegal, but it is reality and gives them all clay feet.

The fact is that Congress won't run its own affairs by sound accounting principles. For them to get pious about business is a joke.

It would be statesman-like if our politicians would admit they have been a large part of the problem and start cleaning up their own corners. Don't hold your breath on that one.

So What is the Truth About Business and the Economy?

Obviously I don't know, but I can make some educated guesses. First, the negative bent of news dissemination overemphasizes the bad and will tend to make people think and feel that things are worse than they really are. I confess to being depressed about it, too. This market hurts. It hurts my Funds, it hurts my clients and it hurts me.

But I also know that my emotions are not a good guide for my investment decisions. My mind tells me to be much more optimistic. Here is why:

1. Emotional depression in the marketplace tends to drive stocks down further than is justified, creating long-term buying opportunities. It is irrational pessimism fueled by the natural tendency of humans to emphasize the negative.
2. Most business executives are relatively honest and are working hard to produce profits for their companies.
3. It will take a lot more than these scandals to derail the entire economy.
4. That these abuses have been exposed will ultimately result in better business practices and more reliable public information on which to base stock values.
5. After every multi-year market downturn, the market has roared back. Consider the following:

1929 Peak – End 1932: Stocks lose 73%	1933-1936: Stocks gain 200%
1937 Peak – End 1941: Stocks lose 34%	1942-1945: Stocks gain 148%
1973 Peak – End 1974: Stocks lose 37%	1975-1978: Stocks gain 70%
2000 Peak – Present: Stocks lose 36%	2003-?: Stocks gain ?%

If I believe that history more often than not repeats itself, then I have to believe that this downturn will be followed by a strong upturn. The big question is whether this market will go down further first.

Downside Risks

Looking for market support levels, we will find one for the Dow at around 8500 and a stronger one around 8000. That would be declines of 3% and 9%, respectively from last night's close.

The S&P500 support level appears to be around 900 and another at around 800. That would be declines of 3% and 14%, respectively.

Upside Risks

Given the historical perspective, it could be almost as risky being out of the market as in it, especially if you want to make real returns above inflation from this point on. To put it in perspective, compare a short-term downside of -9% to -14% to an upside of over 50% over the next few years. Of course, -14% is not necessarily the ultimate downside, but it is a reasonable one. If the stock market retreats more than 14% from current levels, I would have to say we would be looking at a real, major depression.

Managing Your Accounts

So what do you do? At times like these, I recommend doing "zero-base" planning. Imagine that you are starting out fresh, that you have had no losses, and have just been given what you have. How would you invest it?

I have included a couple tools on our web site for estimating how much you need. Start there. Then determine how much risk you are willing to take. (Again, try to clear your head of the emotional damage any past losses have caused.)

Consult your financial planning and investment advisors. They aren't perfect, but good advisors can help you think clearly and offer insights, knowledge and wisdom.

Now make any changes to your portfolios that seem appropriate. And if you need to exercise more discipline and add more to your investments, start doing so now.