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SEVEN QUESTIONS

By IAN MCDONALD



David Tice Offers the Bear Case, Painting a Grim Market Outlook

One wonders if David Tice would be stoned if he strolled down Wall Street. Then again, that might only prove his point.

The manager of the \$502 million **Prudent Bear Fund** sees the glass half empty, to put it mildly. He thinks the folks on Wall Street and Main Street still have a dangerous bias toward optimism: Most stock-fund managers tend to see the bright side, hoping to profit when their share prices rise. But in his fund, Mr. Tice sells stocks short. It's a strategy designed to profit from falling prices and a bold way to make a living given that stocks have tended to rise over time.

Recent market misery has been profitable for the Dallas-based money manager, whose fund averages a 22% annualized gain over the past three years, shorting the likes of **Cisco Systems** and **Sprint PCS**, according to Chicago researcher Morningstar Inc.

Mr. Tice says the bear case is still bulletproof because individual and corporate debt in the U.S. have hit record levels versus the nation's gross domestic product. He believes much of the economic boom seen in the late 1990s was fueled by reckless debt expansion, not skyrocketing productivity. If he's right, U.S. companies and consumers will struggle to pay creditors for years to come, mired in a plodding economy where profits, wages and housing prices tumble. The result would be a brutal economic recession or depression -- a similar scenario was laid out in a Jan. 20 Barron's [cover story](#)¹.

What are the basics of the bear case, and what does Mr. Tice make of the market's gains so far this year, which cost a short seller money? Also, what does such a bleak investor own in his portfolio? We got some answers.

1. After all the carnage we've seen in the market over the past three years, what's the bear case now?

There are three legs to the bear-case stool: stock-market history, economic history and analysis of individual companies.

ABOUT IAN MCDONALD

Ian McDonald covers the mutual-fund industry, writing the Fund Fiend and Seven Questions columns for the Online Journal. Prior to joining the Journal, Ian was a reporter and columnist with TheStreet.com. Before then, he worked in the fund business for several years. Ian was named to The Journalist and Financial Reporter's list of 30 Top Journalists Under 30 in 2001, and won the New York State Society of CPAs Award for Excellence in Financial Journalism in 2000.

A native of Brewster, Massachusetts, Ian has a BA in English from Bates College.

Stock-market history tells you that secular bear markets follow secular bull markets, and they last a long time. There's a symmetry between the longevity and magnitude of bull and bear markets. During the bull market you create imbalances in the financial system. You go from low P/Es [price-to-earnings multiples] to high P/Es. We don't think we've unwound the excesses created in the last bull market to any great degree. Stocks are still selling at more than 30 times their trailing earnings [or about twice their historical average].

As for the economic argument, we believe we're in a credit bubble. We think a reckless expansion of debt fueled the economy's past high growth, more than productivity. Today individual and business debt as a percentage of GDP [or gross-domestic-product] are at record levels. Debt has grown faster than nominal GDP. Usually when credit growth gets out of hand like this, you see inflation rise and then the Federal Reserve takes the punchbowl away [by raising interest rates to cool the economy]. We've seen inflation in asset prices though, not the prices of goods and services. That doesn't bother anyone, so debt just keeps growing in a reckless manner. In fact, asset inflation allows more debt to be created because people can borrow more money [against their house, for example]. It feeds on itself. That's the kind of mania we've saw in Japan [in the 1980s] and here in the 1920s. It ends horribly.

...On a company-by-company basis, the largest 40 companies in the Nasdaq 100 Index are still selling at an aggregate of more than five times their sales [compared to 1.1 times sales for the average company in the S&P 500]. Cisco Systems is selling at more than five times sales. Intel is, too. Companies aren't going to need to spend as much money on technology as they have in the past. We had a once in a generation buildup of PCs, software and networking equipment. This is showing up in these [large tech] companies' results, yet their valuations are still extraordinarily high.

It's a dangerous situation. It will end badly, and it's just a matter of when.

2. How would you define 'dangerous'?

My fear is that [we're heading toward] one of the worst recessions in the last 50 years. A worse recession than what we had in 1973 and 1974. It's hard to say if we get to a 1930s Depression situation.

...I hope I don't come across as someone who is wanting this to happen. At our firm, we've tried to seek out the truth and challenge conventional wisdom. We realize that if our view [comes to fruition] a lot of people will get hurt. They could buy puts [an options strategy to bet against rising prices for an index or stock]. I have a lot of empathy for people who've lost money.

3. Many fund managers say stock valuations are low based on the expectation of rising earnings over the next year. What's your response, and in what scenario is your thesis wrong?

We're critical of the forward-earnings approach to looking at P/E multiples. We think you have to look at trailing 12-months earnings instead because Wall Street [analysts] haven't gotten companies' future earnings right in some time.... Also, there's such a bullish bias on Wall Street with everyone saying everything will be all right. It's extremely dangerous because today companies are dependent on greater and greater amounts of debt to keep the earnings game going.

Also, everyone on Wall Street wants to play the game where they say, 'Ignore all these multi-billion dollar

charges and just look at today's reported earnings.' Well, those charges represent shareholders' money lost, so weren't all past assumptions and prior earnings worse than we really thought?

For example, **AOL Time Warner** came in with **better earnings**² [Wednesday]. But how many billions of dollars have they lost over the past six months? We know accounting is not pristine enough that there hasn't been some benefit from these prior charges on today's earnings. But the game on Wall Street is to say, 'Well, our earnings were 13 cents a share versus expectations of 12 cents a share. Just forget this \$3.35 per share in charges we've booked. And forget that guy behind the curtain tabulating things.'

In terms of how we could be wrong, over a two-year period we think there's very little chance of us being wrong. There's so much weight to the argument on the economic side. But we can certainly be wrong for six or nine months. There could be rallies and the consumer and companies could just keep borrowing even more money.

4. What are your biggest short positions today?

We've been playing defense lately. Right now the game of [betting against weak] companies having trouble accessing the credit markets isn't working. They're still borrowing too much, but that borrowing is keeping them alive a little longer and keeping their stock prices up.

I don't discuss individual names, but we are short consumer discretionary companies, providers of luxury goods. We have been short technology and financials over the past year, but we've reduced our exposure there recently because they've gone up. Short-term rises hurt our performance.

We are more lightly invested than we've been in the past. Our cash position has gone up. We've been on our heels a bit.

5. What do you make of the stock market's gains so far this year, particularly those of the Nasdaq?

Secular bear markets don't go down every day. There are rallies, but we think this is a sucker's rally. Remember, in Japan [the Nikkei 225] is below 8000 from more than 40000, [a high set more than a dozen years ago]. But you've had two rallies of more than 50% over that span.

There's been an extraordinary surge of liquidity in the [U.S.] with corporate debt issuance, junk-bond issuance and asset-backed securities issuance. So, companies aren't having trouble accessing the credit markets [to raise cash]. The Iraq war went pretty well, too. There's also this feeling, which is more numerology than anything else, that we can't have four straight down years in the stock market. We think we still can.

6. Do you think **the SEC's growing interest**³ in regulating hedge funds is an effort to clamp down on short-sellers given that struggling companies often complain that shorts weigh down their shares?

It's difficult to say. There does appear to be some targeting of shorts. We think short-sellers should be commended more for the attention they directed toward Enron and **Tyco International** and other corporate scandals. Shorts discovered those scandals earlier than they would've been found otherwise due to good analytical research.

There's always been a criticism from corporate managers that shorts are targeting them or unfairly spreading rumors about their company. But in the vast majority of these cases where there's been smoke, there's been fire. Management's complaints are often just a way to divert attention from a company's real problems. What managers should say is, 'We will prove them wrong.' Instead, what often happens is that the shorts are proven correct as operational results don't match up to expectations and stock prices collapse.

7. Given your bleak view, where do you invest your money?

I own very few equities. I own mostly gold and mining companies. And I have lots in cash.

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