

After the Bubble

A long, hard market lies ahead. How to find opportunity.

By Jonathan R. Laing

Barrons Magazine

June 29th 2002

(PFD File)

Jim Paulsen recalls the moment as part epiphany and part shock.

It was in April when he realized that more time had elapsed without a new stock-market high than the 484 trading days it had taken the market to claw its way back from the 1987 crash. The realization only reinforced the view of the economist and chief investment officer of Wells Capital Management that something was drastically wrong with the powerful post-1982 bull market, which up until recently seemed to overcome all manner of obstacles in its upward ascent, from the "jobless recovery" of the early-Nineties recession to the Russian ruble and Long-Term Capital Management crisis in the fall of 1998.

"It dawned on me that just maybe the buy-and-hold mantra of today's generation of stock-market investors might at long last be destined for the ash can of history and that a solid stock-market recovery might not be just around the corner," Paulsen told *Barron's*. "In fact, the rules of the game seem to be changing in ways likely to shatter the expectations of millions of investors."

Signs abound that the current stock-market downturn is no typical slump. For starters, stock prices remain mired at levels sharply below their highs of more than two years ago. The Nasdaq sits more than 70% below its March 2000 high of 5048, while the Standard & Poor's 500 Index has sunk some 36% below its record close of 1527. Only the Dow 30 Industrials are within hailing distance of their January 2000 peak of 11,722, though still down some 22%.

More ominous, perhaps, is the fact that the stock-market funk has seemed impervious to all the usual remedies. The Federal Reserve has administered repeated adrenaline jolts of monetary easing since January of 2001 and yet the S&P today is more than 20% lower than it was when the Fed began lowering interest rates. Typically, stocks rebound once the economy begins to recover. Yet prices are down some 15% from this January, when most economists felt the recession of 2001 ended. And at present the stock market seems to be drifting ever lower toward the panic lows it set in September, just 10 days after the terrorist attacks.

Nor does history offer any comfort to today's stock investors. The last three stock-market manias that ended in 1901, 1929 and 1966-68 were followed by 15 to 20 years of horrible average annual returns, ranging between 2% and 5% -- or zero to a negative 1.8% after adjusting for inflation.

And no prior market mania saw anything resembling the magnitude and excesses of the most recent stock-market bubble. Yet most investors, according to recent polling, expect annual stock-market returns to resume their recent 15%-20% pace momentarily. History, regulatory backlash, misunderstood market fundamentals and the continuing stock-market overvaluation all argue that such investor expectations will be brutally dashed.

Still regarded as El Dorado or Golconda, Wall Street may be early on its path to becoming the street of broken dreams.

In the wake of Enron's collapse late last year has come an extraordinary drumbeat of charges of accounting fraud, illegal insider trading, conflict of interest, flagrant self-enrichment and other chicanery on Wall Street and in Corporate America. The luminous financial results of all manner of formerly high-flying companies have been found to be partly mirages created by sham sales, hanky-panky with reserves and balance-sheet games designed to hide operating losses and debt. Supposed defenders of investor interests -- outside directors, accountants and Wall Street securities analysts -- often appeared only too eager to aid and abet the efforts of corporate management to drive their share prices higher in order to pump up the value of huge executive option and stock positions.

A crisis in confidence impends. One suspects that by the time the various congressional committees, the Justice Department, the Securities and Exchange Commission, state prosecutors and the financial media are done investigating the malfeasance, the New Era Bull Market will yield up a rogues gallery of malefactors as notorious as the desperados of the 'Thirties, including Ivar Kreuger, the "Match King"; disgraced utility magnate Samuel Insull; and the New York Stock Exchange president, Richard Whitney, whose defalcations landed him in Sing Sing.

Like Ivar Kreuger before them, a former top officer of Enron and the chief financial officer of [El Paso Gas](#), which is under investigation for sham energy trades, have resorted to suicide. The Rigas family was forced to give up their control of cable company Adelphia Communications after it was charged that they were dipping into company funds to build a championship golf course, help cover the operating expenses of their National Hockey League team, the Buffalo Sabres, and subsidize family purchases of Adelphia stock.

Then there's the former chairman of the conglomerate [Tyco International](#), Dennis Kozlowski, who is being investigated for the undisclosed use of corporate funds to buy an \$18 million condo in New York and outfit it with \$13 million worth of fine art. This all came out recently after Kozlowski was indicted by a Manhattan grand jury for evading a million dollars of state and city sales taxes on the purchase of the art. Last week Kozlowski was also charged with evidence tampering.

Then there's former Global Crossing chief executive, Gary Winnick, who managed to take profit on some \$735 million worth of the fiberoptic network company's stock before accounting and operating problems sent the company into bankruptcy. It took former corrupt heads of state such as the Philippines' Ferdinand Marcos and Zaire's Mobutu Sese Seko decades to skim off that kind of wealth. Winnick did it in less than four years.

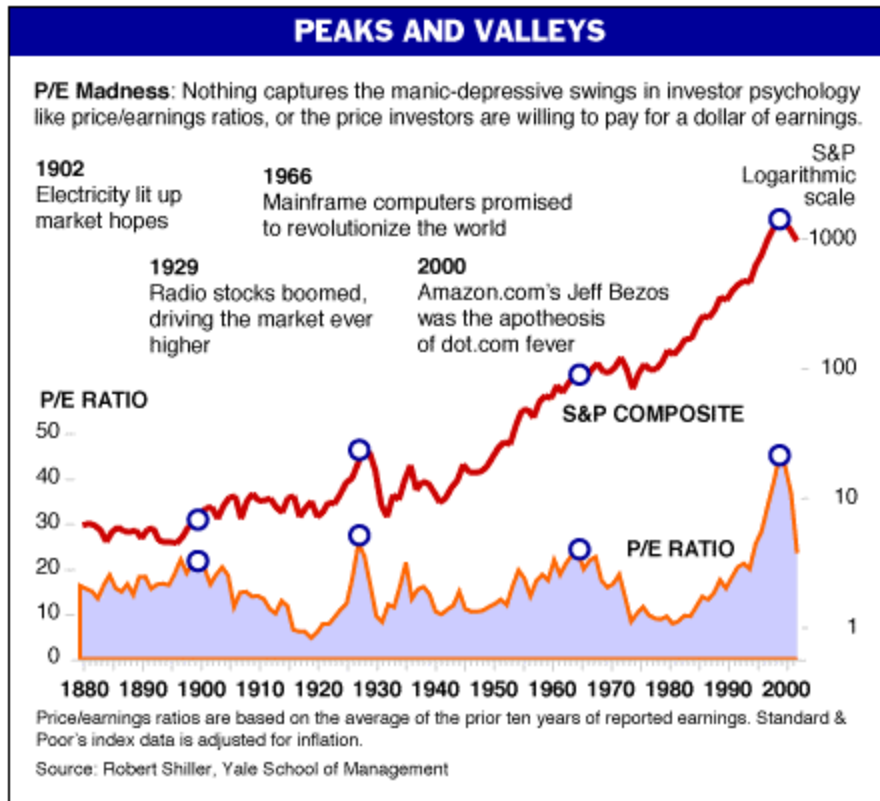
And currently in the news is the former chief executive of [ImClone Systems](#), Samuel Waksal, who was arrested in his pajamas by the FBI at his SoHo loft home. Waksal is charged with securities fraud for tipping off family members and acquaintances to dump the biotech company's stock just one day before the Food and Drug Administration rejected the company's application for a new cancer drug and sent the stock into free fall. His pal Martha Stewart is likewise caught up in the web of suspicion.

And just when the jaded investment public thought the drumbeat of accounting scandals had run its course, [WorldCom](#) dropped the biggest bombshell of all last week. It fired its chief financial officer and revealed that the company had fraudulently padded its earnings over the past five quarters to the tune of \$3.8 billion by shifting operating expenses off its income statement and onto its balance sheet.

Even some of the icons of the post-1982 bull market and economic booms are coming in for some knocks. Former [General Electric](#) Chairman Jack Welch is now embroiled in a very public and tawdry extra-marital love affair, while GE's stock has dropped more than 50% from its all time high over concerns that the company's financial results may have been "managed" to give them more consistency and luster than they might otherwise have had. Robert Rubin, former U. S. Treasury secretary and now Citigroup vice chairman, damaged his reputation of public probity by trying to get a Treasury Department official to muscle the credit-rating agencies to go easy on major [Citigroup](#) borrower Enron so that the energy company could stave off bankruptcy. It didn't work.

Seemingly we're witnessing the unwinding of an era, which commentator Kevin Phillips, on a book tour to promote his latest offering, "Wealth and Democracy," has already dubbed America's second Gilded Age. To Phillips, the 'Eighties and 'Nineties bore unmistakable similarities to previous eras of rampant plutocracy and excess such as the first Gilded Age, which included the closing three decades of the 19th century, and the fabled Roaring 'Twenties.

In all three periods, wealth became increasingly concentrated at the highest reaches of the income scale even if some of it trickled down to working stiffs in the form of some rise in real wages. In just the past several decades, for example, average CEO compensation has soared from just 40 times the wages of median workers to over 400 times.



- The first major peak in the price/earnings of the Standard & Poor's Composite came in June 1901 when the index soared to a multiple of 25.2 times earnings. Marconi made the first transatlantic radio transmission that year and electrification, just starting to be commercialized, fired imaginations of what was to come.
- During the celebrated September 1929 stock-market peak, P/E multiples hit the unprecedented level of 32.6 times earnings. Car ownership soared. Electric power became the pre-dominant energy source. And most homes boasted vacuum cleaners and the magical new toy of the era, the radio.
- The 1966 peak came near the apex of what some call the Kennedy-Johnson bull market when valuation reached a high of 24.1 in January. Federal spending was cranking up to deliver on its dual promise of winning the War on Poverty and in Vietnam. And innovations in computer technology and business management techniques seemed to offer unlimited growth potential.
- Nothing in stock-market history can approach the January 2000 P/E peak of 44.3, at the height of the Internet boom. The price/earnings ratio of the S&P 500 slipped back to 26.5 last month. But if past bubble peaks offer any guide, multiples still have years-and many points-of further decline.

Other similarities exist, argues Phillips. Among them, he cites rapid "**financialization**," or the wanton creation of new trading instruments; the conviction that economic cycles can

be controlled; celebration of new business models; deification of revolutionary technologies; belief in the lusty pursuit of self-interest; exaltation and showy display of wealth, and, of course, rampant self-dealing and corruption.

Such periods, of course, invariably give rise to anti-business sentiment and spasms of severe regulation. The excesses of the first Gilded Age, for example, provoked the Progressive Era and trust-busting of Presidents Teddy Roosevelt and Woodrow Wilson. The New Deal attack on economic royalism and big business likewise grew out of the economic collapse of the early 'Thirties. The resulting environment of stiffer regulation, legal attacks and higher taxes, however necessary, is rarely salubrious for either big business or financial markets.

Historian Arthur Schlesinger Jr., who has written extensively on the ever-changing cycles in U.S. history between faith in private-market solutions and public action, sees just such a sea change developing yet again. "Enron and its aftermath has created an atmosphere that reminds me a good deal of the 'Thirties, when a great deal of securities regulation was passed and the SEC created," he told *Barron's*. "Even the Bush administration, though dominated by a pro-business ethos, now understands in the wake of 9/11 that there are many things like security that government can do better than the private sector."

No institution but the stock market registers with such precision the seismic swings in emotion between pie-eyed optimism and abject disillusion or insensate greed and grinding fear. By this measure, the post-1982 bull market dwarfed all of its predecessors by a wide margin. The Dow and S&P both rose more than eleven-fold between 1982 and 2000 -- nearly three times the magnitude of their rise during the 'Twenties. The five years in a row from 1995 to 1999 that the S&P jumped 20% or more was unprecedented.

It can certainly be argued that some of this move was justified by improving economic fundamentals such as declining inflation and strong corporate earnings growth, at least during the 'Nineties. But not all of it.

Manias, as their name implies, are also about irrational behavior and investor animal enthusiasm run amok, asserted Yale economist Robert Shiller in his prescient 2000 stock market tome, "Irrational Exuberance." Vivid story telling, whether about the future of the Internet in 1999 or the radio in 1929, can fire investors' imaginations to extraordinary levels.

For proof of this, one has to look no further than a chart of the price/earnings ratios of the S&P Composite Index Shiller compiled going back to 1881. To be conservative, he uses a moving average of the previous 10 years of reported earnings for the composite so as not to artificially boost his P/E measure during recessionary periods such as the 'Thirties, when the earnings portion of the ratio shriveled. Both the prices and earnings of the index are adjusted for inflation.

The peak in the chart, which stands like Mount Everest, was a P/E ratio of 44.3 reached in early 2000. It looms over the previous highs notched in 1901 at the end of the first Gilded Age; 1929 just before the Crash; and 1966 when the post-World War II bull market reached its apex. By contrast, investors were only willing to pay around ten dollars for a buck of

earnings in the late-'Seventies and early-'Eighties, compared to four times that amount in 1999.

By Shiller's measure, investors are still remarkably optimistic. His latest monthly P/E reading still sits at 26.5, which is above its 1966 peak of 24.1 and not far from the September 1929 high point of 32.6. He sees the same complacency at work in the monthly surveys he sends out to a random group of individual investors, under the aegis of the Yale School of Management, asking questions such as how much they expect the stock market to rise or fall in the coming year or if stocks were to drop 3% tomorrow, whether the stock market would continue lower or rebound the following day. Surprisingly, investor responses indicate greater optimism now than at practically any point in the 'Nineties bull market. "These survey results absolutely astonish me," he says.

Yet investors so accustomed to 15%-20% annual gains before 2000 might be interested in the S&P's performance during the long hangover periods following the previous bubble peaks captured in Shiller's P/E chart in 1901, 1929 and 1966. Average annual returns slipped to 4.3% from August 1901 to August 1920, 2.27% from September 1929 to September 1949 and 5.09% from January 1966 to August 1982. Real annual returns, removing the effect of inflation during World War I, World War II and the 'Seventies, sank to paltry levels of 0.10%, 0.63% and minus 1.79% during the respective three periods. In other words, investors faced 15 to 20 years of torture after each fall.

Much of today's optimism rests on investors' conviction that the recession is over and a robust recovery is in full swing. Surely the consumer will continue to spend with abandon on homes, cars and other durables. A revival in business capital spending is just around the corner. And who can doubt the reality of the New Economy productivity miracle, after the measure of output per worker-hour rose more than 8% after inflation in the first quarter.

Confidence in Greenspan

Nobel economist Paul Samuelson believes that the U.S. can avoid the gross policy mistakes that resulted in the Great Depression and the grinding stagflation of the 'Seventies. "We learn from the past even if it doesn't give us a skeleton key for the future," he explains. "I really believe that Greenspan and other key policy officials can continue to make smart, pre-emptive moves to give us a decent recovery. The stock market will likewise be bolstered by the yen investors have developed for equities over the past two decades."

If P/E ratios fall, however, the stock market will cave in the years ahead even if profits exhibit sprightly growth. In the 'Seventies, for example, the stock market was largely a range-bound flatliner despite a tripling in corporate profits because P/E multiples collapsed during the decade.

Yet many investment strategists and other self-proclaimed gurus assume that today's subdued inflation and low interest rates will continue to bolster P/E ratios at a high level. As the argument goes, the stock market's main competition is the bond market. As long as yields remain low on bonds, stocks can continue to trade at elevated P/E levels.

The S&P currently trades at 25 times Standard & Poor's official estimate of 2001 operating earnings. To equate that measure with bond yields, the P/E ratio must be turned inside out. The result is the market's "earnings yield," or the cash return an investor would get from the stocks in the index if all of their earnings were paid out as dividends. The current earnings yield, calculated by dividing 25 into 1, is 4%, or more than a full percentage point above two-year Treasury notes.

But Wharton economist Jeremy Siegel pokes holes in the theory that low inflation and interest rates are sufficient to explain high stock valuations today or during other periods. Siegel is worth listening to. His mid-'Nineties classic, "Stocks for the Long Run," correctly predicted the stock-market blow-off. Moreover, he wrote a prescient op-ed article in The Wall Street Journal in March 2000, at the very peak of the Nasdaq, branding such tech darlings as Cisco Systems, Sun Microsystems and Oracle, then selling for over 100 times earnings, as "suckers' bets."

According to Siegel, even though a drop in inflation and interest rates would appear to reduce the competitive tug of bonds and therefore allow P/Es to bob higher, such an environment would also tend to diminish the growth rate of earnings. "Over long periods of time, changes in inflation rates cause changes in earnings growth of the same magnitude and therefore don't change the valuation of stocks," he explained.

His conclusion is likewise supported by historical data. The P/E ratio for the market in the late 19th century and the first half of the 20th, a period of mostly subdued inflation similar to recent months, averaged 13.8. This number was almost the same as the 14.1 average P/E recorded from World War II to 1997, a period of much more intense inflation. Thus, if low inflation is offered as an explanation for today's high P/E ratios, then P/E ratios before World War I should also have been higher than those reported after the war.

Siegel also takes a dim view of yet another bedrock assumption of today's bull crowd, namely that faster economic growth fueled by accelerating productivity gains will inevitably push stock prices higher. **Economic growth, he points out, requires companies to boost capital spending to meet increased demand. Capital, of course, costs money. So either companies' interest tabs rise if they tap the debt market, or per-share earnings results are diluted from the issuance of additional stock. Thus, added revenues always come at a price.**

Then, too, analysts erroneously assume that investment in productivity-enhancing technology leads to permanent boosts in corporate profit margins and earnings growth. More often than not, competitors quickly avail themselves of the same new technology and any productivity gains are quickly "competed away" in the form of lower prices.

Also, much of the spending on technology is merely defensive, designed to preserve rather than enhance profit margins, says Siegel. In today's Darwinian environment of global price competition, productivity gains have mostly redounded to the benefit of the consumer in the form of cheaper prices and enhanced purchasing power rather than bolstering corporations' share of national income.

Stocks in the decade or two ahead may also be flying into the headwind of slowing revenue growth that, in turn, is likely to make bottom-line growth harder to come by. That,

at least, is a theme that Wells Capital Management's Jim Paulsen has been harping on for some time.

He notes that nominal GDP, his proxy for the U.S. economy's sales growth, has grown at an annualized rate of just 5.23% since 1990, compared with a 7.69% growth rate in the 'Eighties and 10.74% in the 'Seventies. Declining inflation is, of course, part of the explanation for slowing sales growth. Yet the 'Nineties rate is also below that of the low-inflation 'Fifties, which posted annual growth of 6.67% and the 'Sixties, with a 6.93% annual rise.

Other factors are also at work in what Paulsen calls the death of sales. On the supply side, technology and increased competition after the fall of the Iron Curtain have vastly increased productive capacity and hurt pricing.

Subtle factors have undermined demand growth, as well. The aging baby boomers are now spending less proportionately than they did in peak consumption years of the 'Seventies and 'Eighties. Debt-engorged household, corporate and government balance sheets have resulted in a dramatic slowing in the growth rate of U.S. nonfinancial debt, from a peak growth rate of around 15% in 1987 to a post-war low of around 4% during the early 'Nineties. Debt growth has remained muted since, attenuating a huge multiplier effect on consumer demand.

Similarly, federal spending as a percentage of GDP has dropped steadily from a non-wartime high of 23% in the 'Seventies to below 17% in the past several years. Even the war on terror and spending on homeland security spending aren't likely to change this long-term picture dramatically, given latter-day voter antipathy toward deficit financing.

Nevertheless, U.S. corporate profits grew at approximately twice the pace as sales during the 'Nineties. We now know that some of this extraordinary performance was the result of slick accounting games. Paulsen also credits U.S. managements' ingenuity in slashing away some 40 years of cost bloat, rampant industry consolidation, which produced new economies of scale, and margin enhancements that came from decades of heavy spending on new technology. But now, Paulsen fears, Corporate America may have reached the point of diminishing returns in both cost cutting and margin boosting: "I suspect that the profit growth rate will crunch down to the anemic sales growth rate. I don't think this augurs well for stocks over the next few years or so."

Stock prices figure to be weighed down over the near term by a host of factors. The dollar is weakening, which both discourages foreign buying of U.S. securities and other assets and potentially fans inflation by making imports more expensive. U.S. budget surpluses, until recently swelled by rich revenues from capital-gains tax payments by stock investors, have now swung into deficit for the foreseeable future. Some investors worry that interest rates and inflation are headed higher.

One wonders whether the stock market will be affected by a fundamental shift in the U.S. zeitgeist. Two-and-a-half tough years in the market have cured many investors of their preoccupation with stocks. Televisions in hotels and bars have switched back to CNN and ESPN from CNBC. Cocktail-party chatter has turned to other topics. As The Wall Street Journal sagely noted recently, stock investing is no longer cool.

Fear of terrorism hurts the stock market in a myriad of ways. Increased government spending to fight terrorists both home and abroad seems likely to consume much of the peace dividend that the U.S. enjoyed with the end of the Cold War. Meantime, corporate profits will suffer from higher spending on security, insurance premiums, necessary inventory redundancies and transportation.

Some observers even worry that the very principles of free global movement of goods and capital that have proven so beneficial to U.S. corporations in recent decades may come under assault. So far, the anti-globalist forces have the disheveled appearance and agendas of the early Vietnam protestor crowd. Yet U.S. allies in both Europe and Asia are bitterly complaining about the Bush administration's approval of both onerous tariffs on steel imports and a farm bill loaded with export subsidies. The forces of protectionism and economic nationalism, though inchoate, are nonetheless worrisome.

No one can know with any certainty what lies ahead for the stock market. Abby Joseph Cohen, Goldman Sachs' investment strategist, is currently forecasting a 30% jump in the S&P for next year. She, like many Wall Street strategists, has lost her following as a result of her unalloyed optimism during the market agonies of the past several years.

[A Losing Decade Ahead](#)

Robert Shiller, as a student of stock-market history and investor behavior, sees 2000 as the crescendo of just another stock-market mania to be followed by a decade or more of lackluster returns. At best, he thinks stocks' returns will be flat to negative over the decade.

Even the generally bullish Jeremy Siegel is somewhat tempered in his view of U.S. stock performance over the next decade or so. The current S&P P/E of 20 to 25 times analyst estimates of 2002 operating earnings implies real return of only 4%-5%. He then adds a couple of percentage points to this return estimate to take inflation into account, boosting his expected nominal return to 5%-7%.

That's assuming that P/E ratios hold up at current levels, as Siegel expects they will, despite their historic elevation. Transaction costs are cheaper than ever before. Low inflation, low dividend-payouts and low capital-gains rates allow investors to enjoy higher after-tax profits on stock trading than in the past. Moreover, he thinks U.S. companies will derive some cost benefit from all the cheap telecom and Internet capacity created by long since busted-out bubble enterprises. And certainly, the U.S. deserves some stock-market premium for still being a magnet for the world's best technology and entrepreneurs.

Still, Siegel worries that investors, conditioned to lush double-digit returns, won't be content with stock-market returns of, say, 6% a year even if they do handily beat bonds in the process. "Annual market returns could come in a lot lower, if investors get disenchanted and abandon stocks for some other game," he says.

Whatever the future holds, the post-1982 bull market will take on a roseate glow as time goes on. Such is the power of nostalgia that memories of the gut-wrenching 1987 crash will soon fade. Few will recall the abject fear they felt during the Long-Term Capital crisis in the fall of 1998. Nasdaq 5000 will take on the numinous being of target that perhaps an entire generation of investors will strive to reach but never attain.

The bull market was exhilarating and all-consuming for many. It brought none of the pain and disappointment that has been visited on investors since early 2000. One suspects that the hangover from the years of unparalleled returns and speculation is far from over. Huge binges require long convalescences.

THE NEW RULES OF INVESTING

1. Forget the Old Rules. The buy-and-hold mantra that was drilled into investors' psyches by the bull market of the 'Eighties and 'Nineties no longer leads to nirvana. One can't buy the dips anymore and expect to be bailed out. Just look at what has happened to all the bottom fishers over the past two and half years. Most are now losing money with little prospect of any appreciable rebound.
2. Trade the Ranges. Over the next five to 10 years, the stock market is likely to be caught in a trading range, held in check by high valuations and anemic earnings growth. Good tops for that range might be the 2000 highs for the Dow and S&P of 11,722 and 1540 respectively, though it's likely that the two market measures have yet to reach their current cycle lows. Once a range seems to be established, it can be traded, though the terrain could be treacherous for non-professionals. Some investors made a decent living between 1966 and the early-Eighties buying stocks whenever the Dow sank to around 800 and selling out when the average approached 1000. The Dow traversed this no man's land six times during the period.
3. Yield Matters. Embrace stocks that pay healthy dividends. A bird in the hand is better than two in the bush, even if dividends are taxed twice -- and legislation may change that. Healthy dividend payments also indicate that companies are generating real earnings rather cooking the books.
4. Diversify. Bonds prices are no longer moving in lockstep with stocks, which makes tactical asset allocation, or swinging between the two asset classes, even more attractive. Besides, diversification always makes more sense in trying stock market periods.
5. Shun the Old Favorites. Forget technology for the time being. Groups like gold and energy stocks had mega moves in the early-'Eighties, then didn't play again for a decade or more after their blow-offs. Yet investors will lose a ton just trying to recapture the excitement and adrenaline rush of once-in-a-lifetime bubble moves.