

The False Promise of Extrapolation: Opportunity in Market Panics

Last week the Russell 2000 Index had declined 20 percent from its peak set last July. Such a decline is the usual definition of a bear market. It marks the first time stock prices have retreated to this extent in seven years.

For many investors this is a cause for panic. Human nature being what it is, the most credible forecast is the one that extends the most recent past. If the market is going up people assume it will keep going up to the sky and buy in with scant regard for the value received for the price paid. If the market is going down people assume it will continue to do so and sell to avoid further declines, lest the investment go to zero.

The problem with this strategy is that most investors do not practice it very wisely. To buy simply because others are buying gives no regard to the dynamics of what is being purchased. Stocks are not casino chips or racehorses. They are pro-rata shares of a business. Yet not one investor in a hundred has a clue as to the dynamics of the industry they invest in. Further, not one investor in a thousand has any idea of the dynamics of the company whose stock is being purchased. Given this ignorance, it is not surprising that markets are volatile. What is surprising is that they are not more so.

The panic *du jour* concerns the sectors of the market that have experienced the greatest gain over the past up cycle: housing and financial stocks. After being bid up and leading the market's advance for the past seven years, the valuation of such stocks became stretched. It is now contracting to the consternation of those who came late to the game. Add to this the aggressiveness of the outside auditors who, having seen the ghost of Arthur Andersen, demand ever more aggressive write-offs by their clients.

Also the rating agencies have been playing both sides of the street for years, charging companies for the ratings that dictated the cost and even access to credit while offering consulting services to help the same firms enhance their investment grade from the same. The public and many banks and foreign investors, not onto the conflict of interest, took investment grades at face value to their eventual regret.

All this took place in an environment in which “free markets” were the mantra of the politicians. When markets are free they are not always level in that one party enjoys an advantage in information or influence over another. Markets free of political supervision in theory are lower cost. They also cater to the darker side of human nature. Along with other political influences such as lobbying, free markets began to resemble less of a paradise and more of a jungle.

At this juncture it is important to understand what one owns, or to trust someone who does. Market panics are wonderful times to buy stocks and bonds. Two of the wealthiest people in the world owe their success to being willing to invest when others would not. Warren Buffett made his first big money buying up stock of American Express during a scandal in which the quantity of salad oil in storage tanks financed by American Express was inflated. Carlos Slim of Mexico took advantage of the panic inspired by the Mexican peso devaluation in 1992 to acquire on credit any number of companies at bargain prices. As a result he is now the second wealthiest man in the world.

Those who advocate in this environment selling out and going to the sidelines with one’s cash typically do not have a strategy for re-entry to the market. While selling out would seem to cater to the human instinct to avoid loss (however unrealized), the bottom of a panic can never be known except after the fact. What usually happens is that the panicked investor becomes so comfortable in cash he or she misses 50 to 100 percent of the next up-leg. At that point bargain valuations have disappeared and the hapless investor is investing due to the success of others. This is usually a sign of a market top.

The key issue here is: what is the time frame for the funds invested? If the time frame is short the funds should be invested accordingly: money market funds, CDs or the like. If the time frame is long select stocks and some bonds can be a better bet.

Many investors become short-term oriented at market bottoms and long-term oriented at market tops. Such timing is a recipe for inferior performance. Unless one believes an investment is going down and not coming back for the foreseeable future it is best to keep one’s head when everyone else is losing theirs. There is too much capital in the world looking for a place to invest to make this the apocalypse for all investments, although it may be for some. As the base is formed for the next market advance now is the time to decide what will participate and what will not.

The Economy

Economic activity continues to slow although much of the data reflects past history. The Christmas season was only fair for retailers. Housing weighs on the economy as residential construction continues to contract.

One bright spot is the inventory of homes for sale. Nationally the number is stabilizing after months of increases. Although parts of Florida and California will probably see high inventories for some time, much of the rest of the country is beginning to absorb houses. This is the first step to an increase in residential construction probably later this year.

While there is talk of recession, the dog that so far has not barked is the number of workers applying for unemployment insurance. This figure has been stable to declining, indicating that employers have chosen to hold on to workers rather than let them go and rehire later. This data may also indicate the tightness of the labor market, especially with so many workers taking retirement.

Inflation

Inflation data confirms a rising trend. This is being abetted by the government which has made a decision to stimulate the economy and worry about the inflationary consequences later.

The future course for inflation would appear to be more of the same. Tight labor markets along with another increase in the minimum wage this year make higher wage expenses a given. The weak dollar insures that commodities will stay high in dollar terms. Finally incremental world demand from China, India, etc. coupled with US government encouragement for biofuels supports the notion that food prices will continue to go up. Look for an inflation rate of 4 to 5 percent in 2008.

Interest Rates

With the latest reading of 4.3 percent the inflation rate is already higher than the return on most government securities. This confirms investors' anxieties in that they will flock to an investment that pays less than inflation to gain safety. However, such an investment position is untenable over time as inflation erodes the purchasing power of funds committed to "safe" assets. It is expected that a fall in government bond prices (and corresponding increase in yield) will signal an end to the current market panic.

A second sanctuary has come under attack in the current financial market turmoil. The insurance companies that guarantee municipal bonds against default have had their own solvency questioned due to their exposure to the mortgage securities meltdown. Since almost half of all investment-grade muni bonds carry the rating of the firm that insures them, a downgrade of the insurer could trigger a downgrade in the bond being insured.

While counterintuitive to those who buy bonds for safety, the best value at this time may be the lower grade high yield bonds. These are the only bonds that can generate returns over the current inflation rate by a comfortable margin. While they do carry higher default risk, this is reflected in their yields and can usually be offset by the purchase of a diversified portfolio. Inflation can help immunize the default risk by increasing the value of the collateral. Finally, unlike Treasury and high grade bonds, high yield bonds have not participated in the current flight to quality.

The Stock Market

One little known factor that has contributed to stock market volatility was the decision last year by the Securities & Exchange Commission to eliminate the "up-tick rule". This rule required those who wanted to sell stocks they did not own (sell short) to wait for the stock to trade higher than its last trade (up-tick) before shorting. The rule's elimination, in the spirit of "free-markets" described earlier, has permitted hedge funds to aggressively push stock prices down by trading with similar computer software. It also implies that the reversal, when it comes, will be equally volatile on the upside.

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