



2nd QUARTER 2001 MARKET COMMENTARY

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THE ELEPHANT IN THE TV STUDIO

The financial TV airwaves are filled with upbeat analysts and commentators explaining in convincing fashion why substantial allocations to common stock will pave the path to profits in the years just ahead. “What’s your favorite stock?” is the tease leading into interview after interview on CNBC. Experienced, respected talking heads make reasoned arguments that Federal Reserve rate cuts revive economic growth with a six to nine month lag. Economists point with confidence to shrinking inventories and to the soon-to-arrive tax refund checks that will certainly provide economic stimulus. Financial show hosts and guests alike highlight the fact that much of the current and prospective business and economic malaise has already been priced into stocks. Abby Joseph Cohen recently contended: “Investors have priced in the worst possible scenario.” Many remind us that, despite declining economic indicators and falling corporate profits, the stock market is an anticipatory mechanism. Since brokerage firm strategists tell us that stocks often turn up six months before business improves, we are counseled to make our commitments to stocks today.

Interestingly, nobody has pointed to the elephant in the TV studio. Perhaps because of selective booking, nobody gives more than a passing nod to the fact that stocks in the aggregate are selling at prices that make no sense. But for a few years at the end of the 1990’s, common stocks in the United States have never sold for price-to-earnings ratios as high as today’s 26.8 on the S&P 500. That is nearly twice the long-term average of about 14.5.

To understand the absurdity of today’s prices, consider the following exercise. Assume that we have not already gone through the late 1990’s and the explosion of price-to-earnings ratios to unprecedented levels. Imagine that a stock salesman came to sell you on the idea of buying “the market” at nearly 27 times earnings while earnings were declining rapidly, as they are today. A quick retrospective of market history indicates that only twice before the 1990’s has excessive investor enthusiasm led PE’s as high as the 25 level. Each of those instances preceded a destructive bear market that wiped away a decade or more of investment profits. Your stock salesman’s suggestions seem like lunacy.

The only reason that such suggestions, being made regularly on TV and in the press, do not strike us as ridiculous is that we have been desensitized by the even higher multiples the market experienced over the past few years. Without critical analysis, most people seem to have accepted these multiple levels as reasonable precedent. By comparison, today’s prices seem to represent attractive values. And many “value” managers are having no difficulty finding securities that meet their liberalized valuation criteria. Either unaware of or deliberately avoiding a confrontation with the facts, managers and commentators are blithely ignoring the fact that, except during the late 1990’s, no investors in U.S. history have avoided huge, lengthy declines when buying a broad cross section of equities even close to the current levels of valuation.

To justify new era valuations, advocates are faced with the task of explaining why it’s different this time. Reasons were rampant and widely believed through the late 1990’s. The collapse of most “new economy” stocks since early 2000 certainly undermined those reasons. We have learned once again that the business of technology is cyclical. We observed that the business cycle for the entire economy is not dead and that increased productivity does not prevent business slowdowns precipitated by inventory excesses. The myth that a never-ending flow of funds into 401(k) plans would keep stocks from a serious bear market was laid to rest.

Although the rationale for unprecedented levels of valuation has been debunked, historically excessive valuations live on. It is perhaps understandable that investors and portfolio managers whose careers began after 1974 remain unafraid. They have never seen their mistakes beaten up and kept down for years. Quite the opposite, especially in the 1990's, they were rewarded for taking valuation risks that had never before been rewarded. If nothing else, most portfolio managers are intelligent people, and if Pavlov's dogs could learn lessons from behavioral reinforcement, stock jockeys certainly could, too. And they did.

We are left with stocks selling at nearly 27 times earnings and the various new era arguments for unprecedented valuations in tatters. Earnings for a great many companies are declining in earnest, and no less august a figure than General Electric Chairman Jack Welch contends that at the very least we are in "an industrial recession" if not a recession that meets traditional definitions. Asked in a recent TV interview when economic conditions might improve, he confessed: "I have no idea." When the dust settles, we expect that the end of century bubble stock prices and valuations will be seen in the light of history as an aberration, perhaps explained simply as an exercise in misguided mass psychology.

If that is in fact what unfolds, the potential consequences are monumental. The bear markets that unfolded after the twentieth century's two most egregious earlier examples of excessive investor enthusiasm, both less severe than the extremes reached just over a year ago, took away the stock market gains of the prior 18 and 16 years respectively. The 1929 to 1932 bear market took stock prices back to the 1914 level, and the multi-year bear market that bottomed in late 1974 brought the Dow Jones Industrials back to 1958 prices.

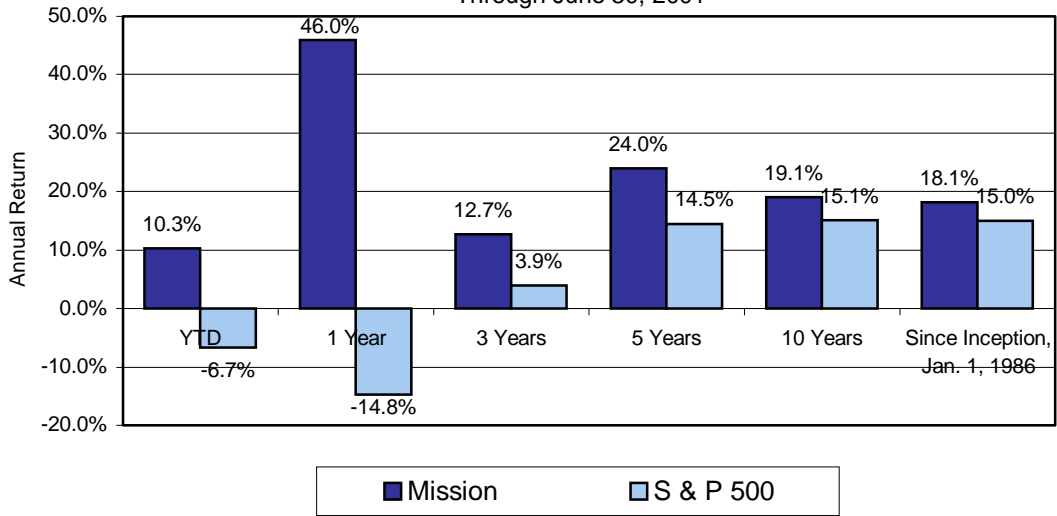
Food for thought – recoveries back to former highs were hardly rapid. The peak from which the Dow began its descent in 1929 was not seen again until 1954, a quarter of a century later. The Dow's high in 1966, near 1000, was not permanently exceeded until late 1982. Unfortunately very few adherents to the buy and hold philosophy of equity investing were around to celebrate these full recoveries.

Unless it truly is different this time, with historical valuations no longer relevant (and we don't believe that for a minute), the reversion to the mean will be painful and costly. Actuarial assumptions will be revised downward with huge consequences to corporations. Consultants will be fired wholesale as their portfolio structuring advice proves counterproductive. Legions of investment managers and stockbrokers will reflect ruefully on their lucrative but ultimately unproductive days in the world of high finance. Worst off, however, will be their clients, both individual and institutional, because it's their money that will be lost.

Reversion to the mean can happen quickly as it did from 1929 to 1932. It need not, however. It could drag on for years, encompassing a series of mini-bull and mini-bear markets as occurred in the 1966 to 1972 period before the ultimate decline that brought stocks prices to their late 1974 lows. While there could still be periodic, significant profits from trading in the latter scenario, the long-term investor will not benefit from being aggressive in equities in either situation. The long-term investor will benefit from paying close attention to historical valuation, waiting for far more attractive levels of valuation before assuming an aggressive allocation to equities.

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Mission Equity
Performance Results
Through June 30, 2001



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