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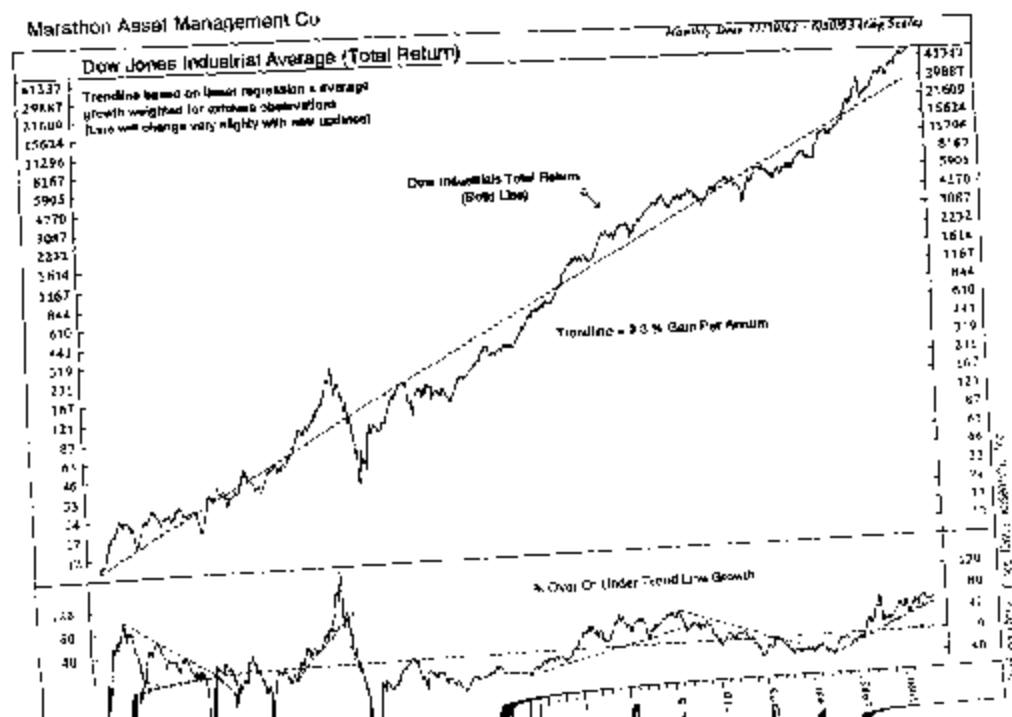
THE SIXTY PERCENT WARNING

By Thomas J. Feeney

The longer an activity succeeds, the more people expect continued success. With very few short interruptions, investing in stocks has been extraordinarily profitable for almost two consecutive decades. The market crash in 1987 was traumatic, but short-lived, the entire decline taking place in less than two months. So quickly did it unfold that most portfolio managers were frozen into inactivity. The failure to protect against a 36% decline was masked by the fact that the equity markets actually registered a gain for the full calendar year. Equity investment in virtually any other period since the end of 1974 has proven enormously rewarding. Investors exercising anything short of unqualified bullishness have been penalized for their caution. Are the

hordes of new mutual fund buyers, however, jumping on the gravy train or the slippery slope to portfolio losses and lengthy disappointment?

Putting great stock in the lessons of history, we examined the past 90 years for guidance in the current situation. The accompanying graph demonstrates that the total return (dividends plus capital gains) on the Dow Jones Industrial Average over that nine decade period has averaged 9.3% per year. A visual examination of the record reveals that there have been several periods in which the Dow's total return line remained above or below the trendline for a decade or more. In each prior instance, however, stock market rallies or declines have forced the total return line back across the trendline. The



probability of that occurring again is extremely high. More instructive, perhaps, is the time frame in which we might expect such a crossing and what consequences that might imply for equity portfolios.

At mid-year 1993 the Dow's total return line is approximately 60% above its nine decade long trendline. This is just the fifth time in this century that the disparity has exceeded 60%. An examination of the prior four occurrences is instructive. Two of those instances occurred in the very early years of the century, another in the stock market boom of the late 1920's, and the most recent in early 1987. To show how unusual is this level of variance from the long term trendline, we would add only two more observations if we dropped the required premium to 45% over the trendline.

The first observation of a 60% premium over the trendline came in March, 1905, with the Dow at approximately 80. After a small decline, the index continued to rise another 29% to a high of about 103. From that even more excessive level, the index lost nearly half its value back to 53 in November, 1907. That left the Dow, 32 months later, 34% below its March, 1905, level at which it first reached a 60% premium over the trendline.

Less than two years later, in August, 1909, at 98 on the Dow, the total return measure again reached a point 60% above the trendline. The industrials edged barely beyond 100 over the next few months, a mere 3% higher. No progress was made over the ensuing four

and a half years with the Dow declining to a low of 71 in July, 1914, 27% below the initial point of 60% overvaluation and almost five years later.

In the roaring 20's, the total return index climbed 60% above its trendline in March, 1928, to 214 on the Dow. The industrials barely paused for a breath before screaming another 78% higher to 381 in the summer of 1929. As even the most casual student of the market knows, that marked the start of the nation's most painful stock market decline. Precipitous at first, then erosive, the ensuing decline brought the industrials to a level of 41 in July, 1932, 52 months after and 81% below the point of initial 60% overvaluation.

The only example in the post-World War II era prior to our current situation began with a 60% overvaluation in July, 1987, at 2667 on the Dow. In the next month the industrials rose another 2% to a peak of 2722 before falling to the two month crash low of 1739 in October, 1987. That left the Dow 35% below its initial point of 60% overvaluation.

In the current instance, the total return index rose to 60% over its trendline in February, 1992, at 3276 on the Dow. Now, sixteen months later, at around 3500, the Dow rests about 10% above that initial 60% warning level. Two of the earlier examples saw the Dow increase from a 60% premium by more than 10% to its ultimate high, two by less than 10%.

Virtually every investment professional under fifty years of age has learned from personal experience to "buy

the dips." Without exception, since 1974, the purchase of stock when the market declined has been rewarded, not only in the long term, but in the near term as well. More than a generation of investors and investment professionals have learned no other lesson more convincingly. Unless market experience is fated to be "different this time," this will prove to be one of the great "set-ups" of all time. Investors and investment professionals, who have lived through no other scenario, will "buy the dips" until such declines fail to spawn profitable rises. Prior to the past eighteen years, extended stock market declines routinely eliminated the excesses of prior market rallies. When another such extended decline ensues, insecurity born of inexperience will almost inevitably lead to excessive selling once the "buy the dips" approach fails to produce profits for a year or more.

What are the prospects of such an extended decline, and what effect could it have on investment portfolios? The analysis of the four prior examples of the Dow's total return line rising more than 60% over its long term trendline demonstrates the consistency of that overvaluation predicting a decline of the Dow well below its 60% warning point level. In the four prior instances, the decline from the warning level ranged from 27% to 81%. The average decline was 44%; the median decline 34.5%. If we lower the point of analysis to a mere 45% overvaluation, we would encompass two more examples, beginning in 1959 and in 1964. Even dropping to that lesser level of overvaluation, the

predictability of market decline remains consistent and the median numbers change only slightly.

In view of today's almost universally accepted belief that all that's necessary to succeed long term in stocks is not to be shaken out during the declines, let's examine the profitability of that approach. In the four earlier declines from a 60% over trendline position, when did the Dow eventually break above the point of initial 60% overvaluation, nevermore to return back to that level? In the first instance, beginning in 1905, it took over ten years before the market broke permanently away from the initial 1905 level on the Dow. The overvalued condition reached in 1909 was not permanently resolved until 1922 with an appropriate statistical conversion to the new Dow Jones Industrial Average. The worst example was the overvaluation reached in 1928. Despite the fact that the Dow skyrocketed to 381 from the initial 60% overvaluation level of 214, it was not until 1950, a full 22 years later, that the industrial average permanently rose above 214. In other words, if an investor had exited the equity market at the 214 level in 1928 and missed the roller coaster market that followed, he/she would have had almost a quarter of a century to reinvest without having lost an opportunity. Since most of that period was spent below 214, reinvesting, even very gradually, would undoubtedly have been highly profitable.

The 1987 example unfolded much more rapidly. The initial 60% overvaluation level was hit in July 1987. The Dow peaked a month later in

August. The decline was completed in two months. Only the recovery to back above the initial 60% level took any appreciable time, but even that recovery took only three and one half years, by far the fastest recovery of the four. It remains an open question, however, whether or not the market has actually risen permanently above the 2667 level that marked the initial 60% overvaluation back in 1987. Should the current instance see the Dow drop by either the average or the median percentages of the prior four examples, we would see the industrials on either side of 2000, obviously well below 2667. That would mean the permanent break above 2667 would elude us still, and we would already be six years from the initial warning level in 1987.

Although the overvaluation levels never reached the 60% mark in the 1950's and 60's, they did twice exceed 45%. It is important to note that the average equity investor who put his/her money in stocks from 1959 to 1972 had lost money by the end of 1974. The stock market decline of 1973-74 brought the Dow Jones Industrial Average back to its 1958 level. More than a decade and a half of gains were eliminated in that bear market.

Where does that leave investors today? Having reached the 60% level above the historic trendline sixteen months ago and holding now about 10% above the initial 60% level, the Dow is in the middle range of the four previous examples, both in time from and in appreciation over the warning level. A

mean or median decline would bring the Dow back within the 1800 to 2100 range. That in itself is a shocking prospect. Should such a decline unfold, the permanent break above the initial 60% overvaluation point of 3267 could take many years to accomplish. The prior four recoveries ranged from three and one-half to over 22 years. Three of the four took more than a decade, and it is still reasonably possible that the short recovery from 1987's overvaluation hasn't yet been completed.

Technical studies such as this, while appealing to some, are often looked upon as though they had emanated from a crystal ball gazer. Curiously, and perhaps prophetically, this study confirms an earlier and ongoing study of bedrock fundamentals. Should the Dow decline to a level that would bring the Price to Earnings, Price to Dividends and Price to Book Value ratios in line with their century old norms, the market would rest in the low 2000's. Should the rush for the exits in such a decline be precipitous, prices could overshoot on the down side, and the industrials could sink below 2000. Neither prospect is appealing. If, based on precedent, we would not expect the 3276 level to be exceeded permanently for a decade or more, the next ten years could be hazardous to your wealth.

History notwithstanding, nothing about the market's future is certain. The warning flags are flying, however, and it would be foolhardy not to build protection into any investment portfolio at these levels of equity overvaluation.

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