

An Historic Bubble

Cresting the Wave

When people don't want to talk with me about stocks, it's time to buy. When people ask about what stocks they should buy, it's time to hold. And when people come up to me and tell me what stocks I should be buying, it's time to sell.

Peter Lynch

We saw extreme drama in the equity markets last year. Early in the year, we saw the exhilaration, euphoria, and visions of extreme wealth and early retirement. We were offered more advice about what stocks we should be buying than we had ever experienced.

The market was creating a bubble, unlike any seen for at least two decades and possibly seven. Bubbles are created by a pied piper posing as a market theorist who explains his simple, can't-miss new theory and promises no-risk riches if you will just follow his lead. Most investors did.

Our clients missed the thrills in the market in early 2000, just as they did in 1999. However, we did not follow the herd, and we missed a dramatic crash. Allowing us to maintain our investment disciplines and a long-term perspective rewarded our clients. As we neared the bubble's peak in March 2000, we lost more clients than at any time in our 11-year history. Fortunately, we were able to minimize these client defections. We appreciate your patience and your willingness to listen to our concerns about the evolving market environment.

Timing the Turbulence

There are three kinds of men. The ones who learn by reading. The few who learn by observation. The rest of them have to touch the electric fence for themselves.

Will Rogers

Of course, this was a technology/Internet bubble. The Nasdaq Index is a good proxy for the technology sector (over 70% weighting in Information Technology). The Nasdaq was up an astonishing 130% for all of 1999 plus the first ten weeks of 2000 (i.e., through March 10, 2000). That was when the bubble peaked. From the peak, the Nasdaq declined 51% through the remainder of the year. For the two-year period (1999 and 2000), this equates to a 6.2% annualized return. This is a low return for the risk taken. Even worse, because of poor timing (as explained below), the vast majority of investors in this market returned much less than 6.2% per year, not to mention the extreme volatility they experienced.

As clients of CornerCap, you did not try to time the turbulence. You may view this as a missed opportunity; all you would need was a large dose of luck. We have done some calculations, and if an investor did in fact time this change from technology to value stocks perfectly, he would have been up around 60% in 2000. You will probably read about a few investors who did this. These big winners had to take big risks to accomplish that feat, and its rarity suggests that it is more accidental than intentional. All you have to do is be there when lightning strikes!

Instead of timing perfectly, investors have a tendency to do exactly the opposite. This has been a consistent characteristic of investors over time, and it is the foundation of our contrarian philosophy. This imperfect timing was reinforced again in the year 2000. During the period surrounding the peak in the technology/Internet mania (March 10, 2000), investors were pouring money into the technology funds and pulling money out of the more conservative value funds. Instead of the 60% return noted above, if investors timed the change from technology to value stocks exactly wrong, they would have been down around 50% in 2000. As suggested by the equity market indices that ranged from down 6% to down 40%, the average investor was much closer to the minus 50% than the plus 60%. A lot of investors received a painful, educational shock last year. Still, the next time around this gravitational pull toward imperfection and away from perfection will happen again. It is almost guaranteed by the consistency of human factors like greed, fear, and the madness of crowds.

Early Detection

If everything appears to be going well, you are most probably not aware of everything that is going on.

Murphy's Law, Corollary 2

We learned long ago how difficult it is to predict the magnitude and the longevity of irrational crowd behavior in the market place. Certainly, this bubble went much longer and higher than we would have ever imagined. It is interesting to look back at our client reports leading up to the crash of the technology sector that began on March 10, 2000. We were exactly right about the event, but we were over a year early. Here are some of our comments from our client reports:

December 31, 1998 **Internet Insanity** – “We’ve seen a lot over the last 20+ years of institutional investing – Nifty-fifty mania (‘71-’72), energy mania (‘79-’80), personal computer mania (‘81-’82), biotechnology mania (‘91-’92), etc. – but we’ve seen nothing that compares to the current Internet mania.”

March 31, 1999 **The Horse Race** – “This is a market driven by momentum. Investors believe that what has been happening will continue to happen for a long time. In contrast, we have always believed strongly in “regression to the mean,” that everything evens out given time. That is why we expect value and small stocks to do better than the alternatives going forward.”

June 30, 1999 **The Great Gold Rush** – “Not only are the Internet companies continuing to report disappointing current and longer term earnings potential, but the supply of new Internet stocks coming to the market is outweighing the new dollars available to invest in this sector. We believe this pattern will continue, and most of these stocks will come crashing down. Instead of a New World and a new economy, we will simply have a new industry group(s) that will work hard to increase profits to justify the price of their stock.”

December 31, 1999 **Modern Day Madness** – “The rapidly growing industry of choice right now is technology and more specifically the Internet industry. There are many humbling lessons in the past when investors forgot about the rules that govern financial gravity.”

March 31, 2000 **The Beauty Contest** – “In today’s market, an attractive company can move to an astronomical valuation almost overnight. The company captured a lot of the votes. However, the company will not be a real winner over time unless it has a sustainable competitive advantage that will generate sufficient cash flows that can be returned to the shareholders. That essentially defines long-term investing.”

Successful long-term investing is boring, and it always will be. Our perspective from the rear view mirror is that we should have invested in the S&P 500 (giant stocks) in 1998, the Nasdaq (technology stocks) in 1999, and more reasonably priced securities (small/mid-cap value stocks) in 2000. That historical perspective is nice to know, but what do you see out the front windshield. Where is the place to be in 2001?

There are several important lessons to learn from the last few years of the market. The principal lesson that we are making in this report is that none of us can time markets or sectors with any probability of accuracy. However, we do believe that we can identify extremes that are occurring in the market.

The Next Extreme

If something can't go on forever, it will stop.

Stein's law

A valuation extreme occurs when everyone agrees on a particular investment. When everyone agrees on a particular buy strategy, then most investment dollars are already there. Going forward, there will tend to be more sellers than buyers. This is what happened with the technology/Internet bubble. The market began its transition from a buy strategy based on greed and a sense of well being to one based on fear and disillusionment. We do not believe that the transition is complete. Not much has changed with regard to the long-term business fundamentals; technology and the Internet will still be the primary drivers for the future success of companies. But that does not mean that technology stocks should be bought at any price or that this downward cycle will stop any time soon. While there are no guarantees in the marketplace, our experience tells us that this valuation extreme is history, and that it will not repeat itself any time soon.

The most obvious valuation extreme that exists today is the S&P 500 Index. It certainly meets the above definition for a valuation extreme—everyone agrees that this is a good investment strategy, and most of the institutional equity investment dollars are either indexed or “closet” indexed into this benchmark. Even investment professionals whom we highly respect like Jack Bogle and Charlie Ellis advocate indexing, and the index of choice is the S&P 500.

Investing in this index is clearly not a contrarian investment strategy. Because of the way it is weighted, the S&P 500 is really about the 25 or 50 largest stocks in the index, and not the other 450. The price/earnings multiple for these stocks is over 30 which is nearly twice its historic average. These stocks will probably not crash like the Internet sector stocks, but like those stocks, they will not be able to maintain an earnings growth rate to support their current prices. We may not know how or when it will happen, but we do know an extreme when we see one. As Microsoft and Cisco have shown us, giant does not always mean safe.

Conclusion

We were over a year early with our concerns about the speculative investing in the technology/Internet sector. Regarding the S&P 500/giant stock extreme noted above, in our December 31, 1998, client report, we predicted that these stocks would under-perform over time, and, thus far, that has been the case. However, like the technology/Internet bubble, this extreme will also be impossible to time. What we can do and will do is to have a well thought out investment process and to follow a discipline that avoids the bubbles and embraces the bottoms. This process has added value over time, and we believe that it will continue to do so.