

Don't Fear the Fall

It's hard to imagine a more perfect recipe for declining stock prices in the months ahead: start with skittish investors, add the historical precedent of falling stock prices in the fall, mix in declining consumer confidence numbers and other indications of a sluggish economy, blend in continuing revelations about corporate accounting scandals and insider selling, toss with high valuations in spite of the abysmal outlook for corporate earnings, then sprinkle with concerns about another terrorist attack as we get closer to the one-year anniversary of 9/11.

Will these ingredients produce another major leg down for stocks? We don't think so. Surprises move markets, not what everyone already knows, and there is nothing surprising anymore about bad news. We have all come to expect it.

The problem with surprises, of course, is that something we cannot see may still be out there to conspire against us (surprises are, by definition, unpredictable). But as we wrote in our last newsletter, playing the odds is the only way to bet, and with every recitation you hear in the media of all the reasons why stocks cannot move higher, the odds get better that they will.

Greater Fools

There is no denying that investors are anxious and afraid right now, and many market commentators viewed the continuing volatility in August as a function of skittish investors selling into every advance – after more than two years of declining stocks prices, it is not surprising that “sell the rallies” has replaced “buy the dips” as the best strategy for making money (or at least not losing it all) in the market.

During the roaring '90s, some cited the “greater fool theory” to explain why Internet stocks with almost no prospects for profitability were being bid up to unprecedented valuations – people were willing to make questionable investments based on the assumption that they would be able to sell later to an even bigger fool. Today a lot of people are feeling like greater fools for having held onto stocks throughout the bear market, and they are understandably reluctant to buy now, if not outright frightened. But that's no reason for you to avoid stocks. We challenge the skeptics to show us a great buying opportunity in the history of the stock market that did not occur in the midst of investor frustration and fear.

Fall in the Fall?

The worst stock market plunges have occurred in October (“Black Tuesday,” October 29, 1929 and “Black Monday,” October 19, 1987), and historically September has been the worst month for the Dow, with an average loss of 1.14% since 1896. Indeed, looking at median monthly changes, September is the *only* month in which stocks have traded lower.

All of this leads the Wall Street Journal to make the following observation: “With the economy limping, preannouncements lurking and talk of an Iraqi invasion growing louder, it's doubtful this will be a September that overcomes the loser status...Many on Wall Street are predicting that major indexes will retest lows hit in late July before they can mount a substantial advance.”

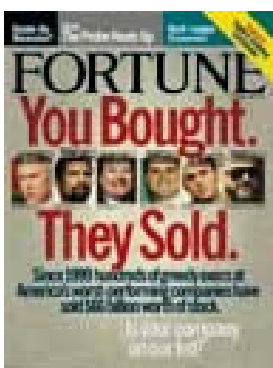
Impossible to imagine that stocks could rise in the face of all this gloom? Think back to the first quarter of this year, when the new conventional wisdom among economists and Wall Street professionals was that the recession had been a mild one and that a robust recovery was underway. Back then it was hard to imagine that stocks would continue declining, especially with all of the experts reminding us that the stock market leads the economy by the several months.

FINANCIA CAPITAL

We weren't convinced, and we predicted a continuation of the bear market. "Right now, everyone knows that the economy is heating up," we wrote in the March 31 issue of *fcNOTES*. "So the current prices of stocks already reflect that knowledge. The question is, what is the most likely surprise that will move stocks higher or lower from here?" Our answer then: a double-dip recession (though one would have been hard pressed to find an economist who agreed with us).

The economic backdrop has changed dramatically for the worse since we made that prediction (it turns out that the stock market does indeed lead the economy!), but our question hasn't: If everyone already knows that the economy is not improving and that many dangers are lurking around the corner, both at home and abroad, then where is the surprise that will move stocks even lower from here?

Our guess is that there isn't one, and that the big surprise in the next several months is going to be *improving* stock prices.



Insider Trading

Everyone knows that many CEOs were quietly selling their own stock in the late '90s, even as they publicly predicted bigger and better things for their companies and the economy. As the cover of the most recent *Fortune* shows, corporate greed at the expense of the little guy has become one of the media's favorite stories: "You Bought. They Sold."

But while the media continues to focus on questionable stock sales of famous (or infamous) insiders that occurred years ago, you should pay attention to what insiders are doing *now*; in spite of the collapse of stock prices this summer, top executives and other insiders have been buying their own shares at an aggressive pace over the past several weeks.

According to the *Vickers Weekly Insider Report*, which calculates sales versus purchases by board members and executives for all stocks reporting transactions in government filings, "Insider trading activity continues to reflect a strong sense of optimism among corporate executives and directors. Their buying appetite appears insatiable." Indeed, the eight-week ratio of selling-to-buying, which now stands at 1.03, has fallen to a level of one sale-per-purchase (or better) on only a few occasions since Vickers started compiling this data in 1971 (there are usually two insider sales or more for every buy, even in rising markets, since many executives receive so much stock as part of their compensation). Nearly every time insiders have shown such enthusiasm for their own stocks, the broad market averages have risen dramatically within the next several months. (You can check out this report out for yourself at www.argusgroup.com.)

If there's one lesson to be learned from all the media attention that has been devoted to criminal insider trading, it's that *insiders know when to sell*. They also know when to buy.

Too Pricey?

In the last issue of *fcNOTES* (June 30, 2002), we told you to expect Wall Street analysts to become increasingly concerned about the outlook for the market, "especially if stock prices appear to be rising too far and too fast." The argument goes something like this: although the 28-month-old bear market saw the S&P 500 fall by nearly 50% at it's lowest point in July, the average price-to-earnings (P/E) ratio remains very high by historical standard, so stocks will need to get much cheaper, or earnings will need to rise dramatically, before a new bull market can begin. And with the turnaround in corporate profits apparently losing momentum along with the Overall economy, those who subscribe to this valuation argument cannot imagine investors pushing up stock prices in the months ahead.

FINANCIA CAPITAL

A seemingly-logical argument, but there are two problems with this line of reasoning: first, as is the case with concerns about the propensity of stocks to fall in the fall, since everyone knows that P/E ratios are high, that fact alone will not impact stock prices going forward. And second, unlike worries about the seasonality of stock prices, historical data reveals *no* statistically-significant relationship between P/E ratios and stock returns in the following year. In other words, high valuations do not necessarily lead to falling stock prices.

Want proof? At the start of 1922, the P/E ratio for the S&P 500 was a lofty 25.8 (not far from where it stands today), yet the index finished the year 27.65% *higher*. Conversely, in January of 1917, the P/E ratio was 6.3, nearly as low as it has ever been, but stocks finished *down* 15.09% for the year. And who can forget 1999, when the S&P 500 began the year with one of the highest P/E ratios ever seen yet returned over 21%? (Had you assumed that stocks simply could not get any more expensive, as many professional did back then, you would have missed out on one of the best years ever to own stocks.) Perhaps you would be comfortable buying stocks if the P/E ratio were half what it is now, say 12 times earnings, as was the case at the start of 1974. Don't bet the ranch if that happens – stocks plummeted a whopping 26.5% in 1974.¹

The bottom-line is that P/E ratios tell us little about the outlook for stocks over the next couple of years. So instead of worrying about valuations, ask yourself why insiders would be buying their own stocks right now if they didn't think they were getting a good price.

One Year Later

What about the risk of a terrorist attack as the one-year anniversary of September 11 draws near? In our January newsletter, we suggested that the media's seemingly-unending coverage of terrorism was reason enough not to worry about another major terrorist attack anytime soon: "the next event to have a major impact on our lives (and our investments) won't be something that the media has been drooling over for months."

Nothing has changed. The intensity and duration of media attention devoted to any major news story is *inversely* related to the likelihood of that story having a material, long-term impact on the stock market, and the increasing focus of the media on the terrorist threat as we approach 9/11 is reason enough not worry about it. So while other investors approach September and October with trepidation, you should look out beyond the gloom-and-doom to what could be very good returns in the months ahead. We can't promise that stocks will rise in the immediate future, but we will be very surprised if the major indexes do not move considerably higher over the next six to twelve months, an outcome that will surprise most market observers.

Last month, we recommended that investors allocate one-third of cash reserves to stocks. Given the continued volatility in the market and our desire to see some positive momentum build to confirm our view, we are maintaining this allocation recommendation. Our guess is that we will see confirmation sooner rather than later, but keeping a fair amount of cash on the sidelines should help you sleep better at night as you wade back into the market.

Sean Bill
Managing Principal

Stephen Brennan
Strategic Analyst

Ian Fraley
Managing Principal

Please send comments to fcNOTES@FinanciaCapital.com

Financia Capital, LLC is a Registered Investment Adviser in the State of California. Nothing herein should be construed as an offer or solicitation of an offer to buy or sell any security. Financia Capital is not rendering or offering to render personalized investment advice or financial planning advice through this newsletter, which is intended only for family and friends of the principals. Advice may only be rendered after delivery of a disclosure statement (Form ADV) and the execution of an advisory contract by the client and Financia Capital.

¹ P/E and returns data from: Fisher, Kenneth L., and Meir Statman, "Cognitive Biases in Market Forecasts," *The Journal of Portfolio Management*, Fall 2000.