FINANCIA CAPITAL

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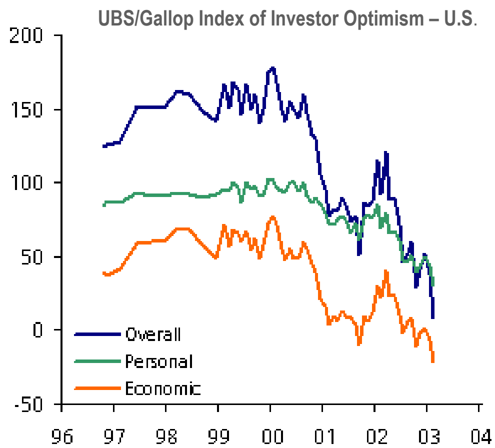
BY IAN FRALEY S&P 500 *841.15* ▪ NASDAQ *1337.52* ▪ DJIA *7891.08* **VOL. 2 NO. 3**

It's What They Don't See…



During the past year, investor sentiment has moved from buoyant to battered to outright bearish.

The weekly sentiment survey of members of the American Association of Individual Investors (AAII) saw bears rise to 57.89% of respondents on February 20. This is the highest level of bearishness since October 1990 (which turned out to be the bottom of the last bear market, three months *before* the Gulf War started). Likewise, the most recent monthly UBS/Gallop Index of Investor Optimism, released on February 24, shows that overall optimism among U.S. investors has plummeted since January, falling from 38 to 9. The percentage of investors in this survey who believe that now is a good time to invest also fell to a record low.

The contrast between investor sentiment today and that seen during the first quarter of last year could not be any more striking. In March of 2002, the UBS/Gallop Index of Investor Optimism came in at 121, just 3 points below its baseline reading of 124 in October of 1996 (deep in the heart of the bull market) and up dramatically from the level of 50 seen in the days following the events of September 11, 2001. On March 14, 2002, 56.5% of AAII members were bullish, while only 14.5% were bearish.

Going to Extremes

In the March 31, 2002 issue of *fcNOTES* ("Decision Time"), we warned that such high levels of investor optimism made it very unlikely that the bear market was over, and we again urged our readers to avoid stocks: "If the consensus is overwhelmingly positive, the most likely surprise is negative. If the consensus is extremely negative, then expect stocks to move up soon in advance of good news."

This was hard advice to follow at the time, as the overwhelming majority of economists (with resumes far more impressive than ours) agreed that the recession was over and that the economy was on the road to recovery. And with the S&P 500 having risen nearly 19% from its post-9/11 lows, most investors were certain that the worst was behind them.

One year later, investors are no less certain that the worst is yet to come. In addition to record-low readings on sentiment indicators such as the USB/Gallop poll, consumer confidence has plunged to the lowest level in nearly 10 years, and January saw investors pull half a billion dollars out of U.S. equity funds, the seventh outflow in eight months and the first January withdrawal since 1990.

But in spite of collapsing investor confidence and rising volatility in the equity markets during the past several months, the major stock market averages remain well above their respective October and July lows, having moved sideways, albeit in extremely choppy fashion, since last summer. And just as investors were wondering back then why the stock market was performing so poorly in spite of all the good economic data, sentiment surveys and equity fund outflows today reveal that they are wondering now when the market will catch up with all the bad news. After all, things look a heck of a lot worse today than they did on July 25 of last year, but the S&P 500 today is exactly where it was on that date.

One need look back no further than the past three years to see that current investor sentiment and future stock returns are inversely related. When opinion goes to extreme levels and investors ignore (or rationalize) information that does not fit their current worldview, surprises favor a different outcome almost by definition. One year from now, it will likely be as obvious that you should have bought stocks today as it is apparent in hindsight that you should have avoided them one year ago (or,

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for that matter, at the start of 2000). This is not a popular view to promulgate right now, but it is no less difficult than trying to convince investors to take some profits in early 2000 or cut their losses in early 2002. If it were an easy argument to make, we would most certainly be wrong.

Sector Selection

Humans are social creatures, and as such we know instinctively that there is safety in numbers. But while this intuition may have helped our ancestors survive in the wilderness, it serves us poorly in modern financial markets.

Since 1987, the mutual fund rating service Morningstar has ranked the nation's three least and most popular fund categories each year by their cash flows as a percentage of their net assets. Over the next three years after each new ranking, the *least* popular funds by this measure have outperformed the average stock fund 75% of the time and have beaten the three most popular fund categories more than 90% of the time. These are compelling odds indeed.

While a strategy based on buying the three least popular categories each year might appear uncomplicated, it is as difficult to implement psychologically as it is easy to conceive of intellectually. Human nature leads us to extrapolate recent trends and "chase" performance, abandoning investments that have performed poorly in the recent past and piling into sectors and asset classes that have enjoyed the most success. The result is that investments that seemed like such "no brainers" a few years ago appear too risky to even contemplate right now, while those that were viewed as having little potential back then (like bonds and gold) are among the most popular today.

Last year's least popular categories according to Morningstar were Latin America funds, utilities funds, and financial services funds. The most popular in 2002 were precious-metals funds, small-cap value funds, and real-estate funds. While gold, real estate, and value stocks certainly sound like good choices in this uncertain economic and geopolitical climate, the Morningstar numbers would suggest that financial services, utilities, and even foreign stocks will outperform over the next few years. When it comes to sector selection, there is no safety to be found in numbers.

Japan Revisited

As negative as U.S. investors are about stocks in this country, they are even more pessimistic about foreign equities. The February UBS/Gallop Index of Investor Optimism reveals that 60% are more optimistic about the U.S. markets than other regional markets. European markets are a distant second with 12%, followed by Japan with 11%.

This caught our eye, since exactly one year ago today we devoted this newsletter to the subject of Japanese stocks ("Contrarian Investing: The Long and Short of Japan," February 28, 2002). While we did not recommend buying Japanese stocks at that juncture (we advised readers to avoid stocks altogether), we suggested that Japanese equities might very well enjoy better returns than their American counterparts in the coming years: "There is a concept known as 'reversion to the mean,' which is based on the observation that all market capitalization weighted stock market indexes (even those in other countries) tend to have similar returns over very long periods of time (30 years or more). Because of this, when stocks as a group experience a prolonged period of higher-than-average growth, they are likely to experience a period of larger-than-average declines to restore the long-term average… The same holds for the opposite scenario: a market like Japan's, which is experiencing an astonishingly-long period of miserable returns… must at some point go through a period of above-average performance to revert to mean."

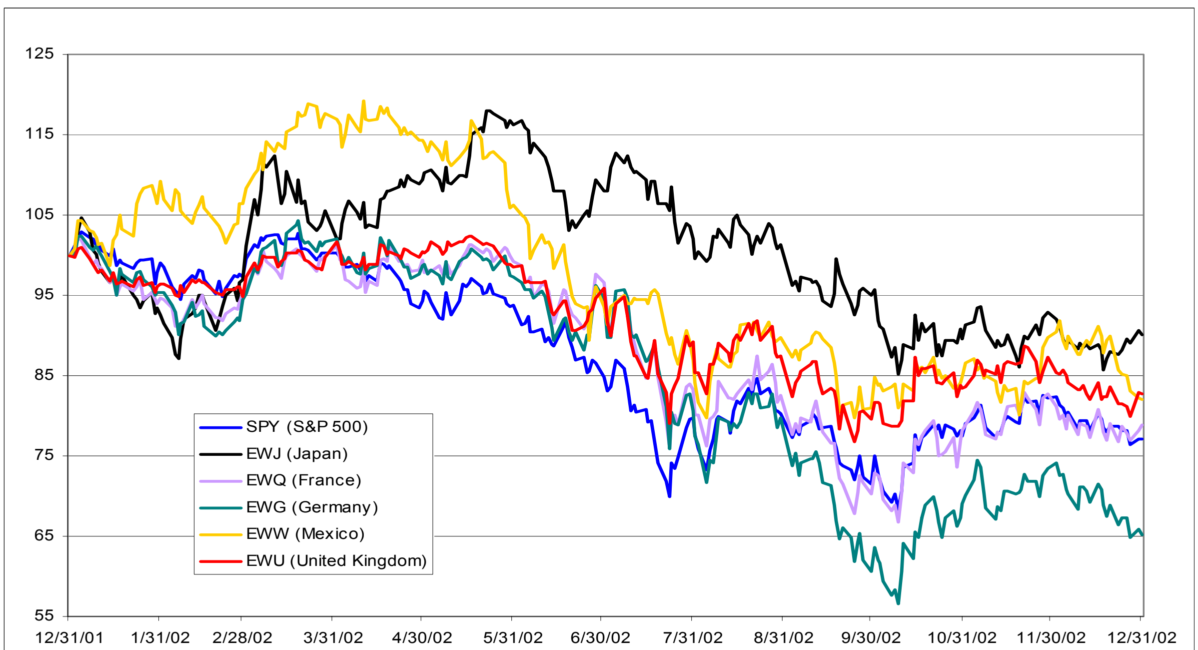
Our optimism for Japan's long-term prospects was based in large part on the observation that even the contrarians had become bearish on that country, resulting in a nearly unanimous consensus that Japanese stocks should be avoided. In the 2002 *Barron's* annual roundtable, a three-part series that appears every January and highlights the investment outlooks of some of Wall Street's most celebrated personalities, the consensus of the group was summed up by this statement from Morgan Stanley's Barton Biggs: "Japan is still a disaster, and getting worse." We pointed out that Barton

Biggs' *favorite* market in 1999 was Japan, and at the start of 2000, Japan remained his top pick. It wasn't until the beginning of 2002 that Biggs threw in the towel on Japan, leading us to conclude, "If investment professionals like Mr. Biggs who have been so bullish on Japan for so long are finally giving up on Japan, having been burned so many times in the past decade, there can be no doubt in our minds that a terrific investment opportunity is not too far off."

In this year's *Barron's* annual roundtable, the silence on Japan was deafening, as none of the participants said much about the subject one way or the other (though they had plenty to say about opportunities in other countries and at home). It was almost as though they had written Japan off completely, finding it as unnecessary to remind investors of the problems in that country as it is to recommend wearing a coat in the snow.

We found this both amusing and significant, since the Japanese market outperformed just about every other large regional equity market last year in spite of its least-loved status among professionals. Surprised? Take a look at these numbers: SPY, the exchange traded fund that tracks the S&P 500 index of U.S. stocks, fell 22.81% in 2002. EWG (the ETF for Germany) plunged 34.83%, EWQ (France) dropped 21.07%, EWW (Mexico) slid 17.98%, and EWU (United Kingdom) lost 17.29%. The Japanese ETF (EWJ) suffered far less damage than any of these markets, posting a single-digit loss of 9.86%. Not bad for the country that is "still a disaster and getting worse."

Japanese Stocks Outperform in 2002



Financia Capital, LLC, February 2003 (daily, 12/31/2001 = 100, source data from MSN)

It seems no one has noticed how relatively well Japanese stocks are doing amid all the doom and gloom in the media, and we think this is important. Overlooked good news during periods of tremendous uncertainty and pessimism is the hallmark of great investment opportunities.

As we acknowledged last year, Japan has been a tempting contrarian play for more than a decade, and it has burned investors every time. But we believe that the bar of expectations has been set so low for Japan that the odds favor these stocks outperforming in the next few years. This presents a compelling opportunity for investors who can ignore the silence of those who have tried and failed so many times in the past to predict a recovery in this beleaguered market. And for this reason, we are currently recommending that investors overweight Japan in the equity component of their portfolios.

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Style Selection

In addition to Japanese stocks and U.S. sectors that have been among the least liked during the past few years, we favor investment styles that historically have performed well at the start of bull markets.

While small company stocks usually get hit the hardest in bear markets, as they are perceived to be riskier than the big-cap "blue chip" names and are thus the first to be sold, small-caps have outperformed big-cap stocks in the early stages of *every* bull market since 1932, and the harder stocks have fallen in the prior decline, the better small-caps have done on the rebound. After the 1973-74 bear (one of the four multi-year bear markets the U.S. has experienced), small-cap stocks more than doubled during the next 7 years (a period in which the Dow actually lost 10%).

More recently, small-caps bested big-caps after the 1990 bear market, as the Russell 2000 index of small-cap stocks far outperformed the S&P 500 from 1991 to 1992, and held this leadership until the mid-1990s. Also bolstering the case for overweighting small-cap stocks right now is research from Ibbotson Associates, which shows that small-caps outperformed large-caps during the twelve months following *every* recession since World War II (see table).

Small-Cap vs. Big-Cap One Year After Recessions

End of Recession[1]	Small-Cap[2] 12-Month Return	Big-Cap[3] 12-Month Return	*Small-Cap Advantage*
10/31/1949	31.4%	30.1%	*1.3%*
5/31/1954	51.1%	35.7%	*15.4%*
4/30/1958	53.5%	37.2%	*16.3%*
2/28/1961	18.0%	13.5%	*4.5%*
11/30/1970	12.1%	11.3%	*0.8%*
3/31/1975	58.1%	28.3%	*29.8%*
7/31/1980	45.1%	12.8%	*32.3%*
11/20/1982	43.6%	25.5%	*18.1%*
11/30/1991	27.5%	11.0%	*16.5%*
Average	**37.8%**	**22.8%**	***15.0%***

Source: *Stocks, Bonds, Bills and Inflation*, Ibbotson Associates
1. National Bureau of Economic Research business cycle dates
2. Ibbotson Small-Cap Total Return Index
3. S&P 500 Index

Curiously, there seems to be a conflict between the historical pattern of small-cap stocks outperforming coming out of a recession and the Morningstar results, which would seem to predict relatively poor performance for small-cap value stocks over the next three years. But researchers at Ibbotson Associates have found that the performance discrepancy between small-cap and big-cap stocks in bear markets only applies to growth stocks and not to value stocks; while small-cap growth stocks get hammered in bear markets, Ibbotson found that small value stocks actually hold up much better, losing only 4.8% on average. And sure enough, small-cap value stocks have performed very well during this most recent bear market, losing only 3.57% during the two years ending December 31, 2002. By way of comparison, small-cap growth stocks plunged 37.92% during the same period, worse than the loss of 33.36% experienced by the big-cap dominated S&P 500.

Is it possible that investors can "have their cake and eat it too" by overweighting small-cap value stocks now to provide protection from downside risk if the bear market continues while also allowing for better results when stocks take off? Probably not. While growth stocks are valuable for their earnings, which suffer in the recessionary climates that accompany most bear markets, value stocks attract investors during slow-growth periods because of their assets – buildings, land, cash reserves, etc. The popularity of "hard" assets in the current climate explains why small value stocks have held up so well, but it also suggests that value stocks will underperform as the rate of earnings growth increases during the period of economic expansion that will follow the start of the new bull market.

For investors with time horizons measured in years rather than months, we recommend creating a diversified portfolio from among the *least* popular sectors, countries, and styles, and we will highlight more of our favorites in the months ahead.

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