

The Y2K Lesson: Enron, Terrorism, and the Stock Market

Earlier this week, a friend asked if she should sell her Tyco stock, given all the media coverage of the Enron accounting debacle and the widespread (and widely-reported) rumors that Tyco might be next. Since we make it a policy not to give investment advice about specific securities in our newsletter, we decided to address the media frenzy over the Enron situation by describing how we use pervasive news reports like this one to shape our market view.

The media almost never identifies the really important problems early – which means that it's what the press *isn't* reporting that should worry you. Recent history has demonstrated that by the time the media jumps on the bandwagon, the perceived danger is either already on the way out – or it never existed at all. Our research has led us to conclude that the intensity and duration of media attention devoted to any major news story is in fact *inversely* related to the probability of that story having a material, long-term impact on the stock market. One can never be entirely certain of anything (a good thing to remember when investing), but since the media frenzy over Enron is now rivaling the coverage of terrorism (more on that later), we are willing to bet that there won't be "another Enron" any time soon.

What Y2K Crisis?

A fine illustration of the relationship between media hype and financial markets is the "Y2K" hysteria that swept through the country in the late-1990s. You couldn't go a day without reading an article penned by a computer expert warning of the chaos that would ensue when computer programs misinterpreted 1/1/2000 as 1/1/1900, a product of the two-digit dating system that had been used by programmers in the early days of computing to save disk space (hard as it may be to remember, there was time when memory was expensive). The experts based their dire predictions on the fact that almost every aspect of our modern life was controlled (or at least influenced by) computer chips and software. Yikes, they howled, don't we realize that even our microwaves and coffee makers have computer chips in them now? Truly we are doomed... (Just think of all those people who won't be able to make coffee!)

Even the more conservative analysts, including Federal Reserve chairman Alan Greenspan, warned that some disruption was to be expected, even if it didn't bring the economy to its knees. All the major news channels aired several special programs on the impending crisis, and there were more web sites than we could count devoted to the topic. And on Wall Street, the stocks of companies that had developed products and services to "fix" the problem soared.

So what happened when the clock rolled past midnight on December 31, 1999?

Nothing.

And lest anyone accuse us of ignoring the fact that countless millions of dollars were spent on "fixing" the Y2K bug, we would remind our readers that even smaller countries (which unlike the U.S. had devoted little time and money to dealing with Y2K) reported few problems. Actually, we can't recall a single incident of disruption more serious than someone's alarm clock not going off, much less any problems that adversely impacted the world's economy and financial markets.

An Ignored Threat

Of course, Y2K can't compete with the media coverage that has been devoted to the threat of terrorism, and for that reason we are also willing to bet that the United States will not fall prey to another major terrorist attack in the *near* future, be it biological, nuclear, or "conventional." (In the

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long run, however, another large-scale attack becomes more likely if and when the media loses interest in the terrorism story and begins ignoring the risk again.)

It was the relative inattention of the media to a pattern of terrorist attacks on American assets abroad and at home throughout the '90s that should have caused the most concern. When terrorists bombed the World Trade Center in February of 1993, no back-to-back, month-to-month, "War on Terror" media coverage ensued, in spite of the fact that this was the first ever terrorist attack on U.S. soil. Perhaps this is due to the fact that "only" 6 people were killed (even if thousands were injured), or maybe it was because the American people had the satisfaction of seeing the perpetrators (at least some of them) arrested, but whatever the reason, the outrage died down quickly and the media soon searched elsewhere for ratings. By the time the Monica Lewinsky scandal broke in January of 1998, Americans (and their media) could not have cared less about terrorism. When 224 people were murdered in the almost simultaneous bombings of two U.S. embassies in East Africa on August 7, 1998, the media yawned – after all, just one day before the attacks, Lewinsky had given her sensational testimony about "the blue dress" to a federal grand jury. Then an American destroyer, the USS Cole, was hit by explosives while docked in Yemen on October 12, 2000, and again the media failed to make the connection. The writing was on the wall, the trend was developing with every attack, but the media failed to catch on. That made it a very real threat, as September 11 all too painfully proved.

No More Enrons

Ironically, the first major news story since September 11 that has commanded anywhere near the same level of media attention as terrorism – Enron – has developed in much the same way. While the common thread running through the escalating terrorist attacks against America was being ignored by the media, a pattern of "accounting irregularities" crippling major U.S. businesses was also being overlooked.

Indeed, it wasn't that long ago that the same accounting firm that acted as Enron's auditor, Arthur Andersen, found itself in the middle of similar scandals involving appliance maker Sunbeam Corp. and waste management services provider Waste Management, Inc. In May of last year, Andersen agreed to pay Sunbeam shareholders \$110 million to settle a securities fraud lawsuit. (After Sunbeam collapsed in 1998 and chairman and CEO "Chainsaw Al" Dunlap was fired amid public allegations of gross mismanagement and fraud, Andersen approved a restatement of earnings for six quarters). Just two months later, in July of 2001, Andersen paid the SEC a record \$7 million fine to settle a civil fraud complaint, which alleged that senior partners had failed to act on knowledge of improper bookkeeping at Waste Management, Inc. Lest anyone think that this is minor compared with Enron, we should point out that the \$1.4 billion restatement of profits that resulted from these accounting problems was the largest in U.S. corporate history. Andersen also agreed to pay Waste Management shareholders \$20 million to settle its securities fraud claims against the firm.

Andersen wasn't the only culprit among accounting firms. In 1999, Ernst & Young paid shareholders of Cendant \$335 million, by far the largest settlement ever paid to stockholders of a company. Cendant, whose brands include Century 21 (real-estate brokerage), Avis (car rentals), and Days Inn and Ramada (hotels), saw its stock price plunge in 1998 after it announced "accounting irregularities" and was forced to restate earnings from 1995 to mid-1998. The scandal led to several resignations, and Cendant's market value dropped by \$14 billion in a single trading session in April of 1998.

So how surprising was it that "accounting irregularities" would cause the seventh-largest company in the U.S. to declare bankruptcy?

The media's seemingly unending coverage of Y2K told us then that we shouldn't waste too much time worrying about it – and it tells us now not to be as worried as we could be about the twin

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threats of terrorism and accounting irregularities (who ever thought those two would appear in the same sentence!)

Don't get us wrong – by no means are we saying that U.S. policy on terrorism and accounting standards should be based on what the media reports (or doesn't report), any more than we are suggesting that computer maintenance is no longer necessary after all the Y2K fuss. What we are saying is that 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.

Still Waiting for Capitulation

Which brings us (finally) to the stock market. In our last letter (December 30, 2001), we suggested that the equity markets had not reached a bottom because the media was more concerned about two or three people out of 285 million contracting anthrax than they were with the devastation the bear market had wrought on almost all of our pocketbooks. Since then the S&P 500 has declined a bit (down nearly 3%). And we think the worst is yet to come.

Way back in the early summer of 2000, following the first big decline of this bear market, we can recall people asking us if it was a good time to buy stocks. After all, companies like Oracle and Cisco were down 20% or more! Our question to them was: what is the biggest story in the news right now? Answer: a little Cuban boy named Elian Gonzales. If the press thought that one little kid was more important than the falling market, you could rest assured that the decline would continue.

By November of 2000, as the attention of media turned from Elian to the drama surrounding the presidential election crisis, the stock market resumed its fall. We can remember George Bush's spokesman during the crisis, James Baker, blaming Al Gore for the stock market decline and suggesting that the market would respond favorably if Mr. Gore stepped aside. Many Wall Street experts (doubtless Republicans) came on TV to reassure investors that the market would recover once the crisis was resolved, especially if Bush ended up the winner. Of course, the crisis was resolved, and Mr. Bush did end up the winner. And stocks continued their slide.

Then in April of 2001, as the Nasdaq fell to 1600 (from an all-time high of over 5000 only 12 months earlier), the market again played second fiddle in the news to another event: the downing of a U.S. Navy surveillance plane by Chinese fighters and subsequent eleven-day detention of the crew on Hainan Island.

Finally, the massive sell off following the terrorist attacks on September 11. Needless to say, the media's focus on those terrible events never wavered, even as the Dow recorded its single worst week ever, and not much has changed since then (though the press is showing a lot of interest in the Enron debacle as events in Afghanistan become less exciting).

The moral of all of these stories, from Y2K to Terrorism to Enron: when the media finally turns all of its attention to the collapsing stock market as the single greatest threat to America, it will finally be time to buy stocks. As with Y2K and terrorism, by the time the media recognizes the danger, most of the danger will have passed.

Until then, stay in cash and watch for bears to replace Osama (and Enron executives) on the covers of the major national news weeklies.

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