

## Born-Again Bulls

What a difference a rally makes.

It seems like only yesterday that the market was collapsing and the bulls were on the run. But with the S&P 500 having charged nearly 22% since the March 11 low, the bulls are back in town – and with a vengeance.

During the second week of June, the weekly *Investors Intelligence* poll of newsletter writers revealed a huge decline in bearish sentiment. Bears plunged to 16.3%, the lowest reading since April of 1987 (we probably don't need to remind you that 1987 was a rather wicked year for the market, though stocks continued to rise for another four months after the low April reading before peaking on August 25, two months before the October crash.)

And on June 26, the American Association of Individual Investors weekly sentiment survey saw bullish respondents rise to an eye-popping 71.43%, while bears fell to just 8.57% (20% were “neutral”). This is the largest number of bulls and smallest number of bears since the start of the bear market more than three years ago; bearishness was 8.3% on September 7, 2000 and 6.7% on September 28, 2000, just days after the S&P 500 failed to make a new high and began a three-year decline. The only other time the percentage of bears has been lower occurred on August 21, 1987, when bears fell to 6.0%, two months before the Crash.

Corporate insiders, however, do *not* share the enthusiasm of small investors and newsletter writers. Top executives and board members are selling shares of their own companies at a pace not seen since the summer of 2001. Last week, the Vickers Weekly Insider 8-week sell/buy ratio for stocks traded on the New York and American exchanges jumped to a rate of 4.11 sales-per-purchase, within striking distance of the multi-year high of 4.18 that was hit on May 29 last year, when the Dow was trading at 10,100 – during the following two months, the Dow plummeted to 7181, a loss of approximately 30%.



How accurate is the timing of insiders? Following the June/July decline, insiders quickly bought back their own shares at much lower prices. In the August 31, 2002 issue of *fcNOTES*, we alerted our readers to the aggressive pace of buying by top executives and other insiders, even as stocks were making new lows in July. As insider buying picked up, selling was also dropping off dramatically; insiders sold only \$882 million in stock during July, the first month since 1997 that they hadn't dumped at least \$1 billion, according to Thomson Financial.

### AAll Sentiment Survey 10 Least Bearish Readings

Date	% Bearish
8-21-87	6.0%
9-28-00	6.7%
9-7-00	8.3%
11-9-00	8.6%
6-26-03	8.6%
3-18-88	10.0%
12-18-92	10.0%
5-30-96	10.0%
9-18-87	11.0%
12-9-99	11.0%

### Mixed Signals

As contrarians, we always get nervous when we find ourselves with too much company, and we are also very much aware of the long history of insiders being on the right side of big market moves, up or down. Does what some are calling the return of “irrational exuberance” among smaller investors combined with heavy selling by corporate insiders spell big trouble for stocks in the coming months?

Surprisingly enough, probably not.

First, the *Investors Intelligence* and AAll surveys present an incomplete picture of market sentiment. While the former reflects the consensus of *newsletter writers*, and the latter is a good proxy for the sentiment of *small investors*, neither tells us anything about the third leg of the market

stool – *professional portfolio managers*, arguably the most important of the three, since as a group they control or influence up to 80% of the trading volume in the market every day.

Second, beyond the fact that so many in the media seem worried about the bullish sentiment of the other two groups (which means you probably don't need to worry, at least not yet), we are hearing and seeing a very high level of skepticism among Wall Street professionals, and this rising anxiety is manifesting itself in both what they are saying *and* what they are doing.

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Third, while corporate insiders as a group seem to have an uncanny ability to buy and sell before major market bottoms and tops, they are almost always early by several months. And our own research suggests that after a long period of stock market declines, heavy insider selling into the first leg of a new bull market may not have the same predictive power as similar behavior during other parts of the market cycle.

We will be watching all of these groups closely in the coming months for anything that might signal a continuation of the 2000-2002 bear market, but as we move into the second half of the year, our advice is to maintain a fully-invested equity portfolio.

## Elite Pessimism

We know from experience that only *extreme* sentiment is a reliable predictor of the future direction of equity prices, and that this sentiment must be shared among virtually all market participants; there is always a lot of noise in the wide space between overwhelming pessimism and irrational exuberance, and most of it is meaningless. The surge in bullishness among individual investors and newsletter writers certainly qualifies as extreme by historical standards, but this high level of optimism is not shared by the professional managers who most influence the direction of the stocks market.

Ample evidence of this can be found in the *Barron's* Mid-Year Roundtable (you can read it in the June 23 issue), a follow up to the three-part series that appears every January and highlights the investment outlooks of some of the most celebrated and widely-followed professional money managers and analysts. The *Barron's* Roundtable is always an enjoyable read, especially since the consensus opinions of the participants are almost always wrong.

At first glance, their outlook for stocks seems optimistic: "Our midyear check-up finds the members of the *Barron's* Roundtable mostly bullish about the near-term prospects for stocks," advertises the contents page of the *Barron's* website. Going to the article itself, we see even more bullish verbiage in the tagline: "The *Barron's* Roundtable pros still predict a strong rally." But as we turn to the contents of the article itself, we have to wonder if the editor who wrote these one-liners even saw the transcript.

"I'm not sure I fully believe it, but I'm happy," said Art Samburg (chairman and CEO, Pequot Capital Management) when asked for his thoughts on the ferocious rally that had added more than 1000 points to the Dow since the March lows. "I worry about corporate profitability more than anything... There's a lot of service-cost pressure on both consumers and

corporations. That could easily lead to profit stagnation."

Like Samburg, John Neff of (retired portfolio manager, Vanguard Windsor Fund and Gemini II) seemed skeptical about the sustainability of the rally in what he predicted would be only a modest economic rebound. "In January I said the market might be up 10% for the year. Well, the Dow is up about 10%, the S&P a bit more. At this point maybe it's a little too happy... It's not going to be a rip-roaring recovery."

Oscar Schafer (managing partner, O.S.S. Capital Management) was a bit more positive in his outlook for stocks but agreed with Neff's muted assessment of the recovery. "In the near term [the market is] going to continue to go up, and not necessarily for any great fundamental reasons... The economy is doing all right. We're not going to have a big boom, but business generally is getting a little better."

Like many of the other roundtable participants, Archie MacAllister (chairman, McAllister, Pitfield, MacKay) and Felix Zulauf (founder and president, Zulauf Asset Management) were concerned that the market had gotten ahead of itself: "I am nervous about it because it has had a hell of a move," opined MacAllister. "All kinds of things could really jolt this market." Said Zulauf, "As for the stock market, the best part of the rally is over. It is not a straight line into next year, because there could be some disappointments in the fourth quarter."

Scott Black (founder and president, Delphi Management) and Meryl Witmer (general partner, Eagle Capital Partners) were decidedly more pessimistic about the fundamentals, pointing to what they believe to be excessively-high valuations. "The market is trading for 22.5 times earnings. It's selling for more than three times book value and yields 1.5%. By almost any metric, that's expensive," said Black, adding, "Evidently some people didn't learn the lesson on 1999-2000." Witmer was more blunt: "I do not see many inexpensive stocks around. I'm neutral to negative about the rest of the year. The market will be flat to down 5% from here."

Even the normally ebullient Mario Gabelli (chairman, Gabelli Asset Management) and perennial bull Abby Joseph Cohen (chair of investment policy committee, Goldman Sachs) seemed more subdued than normal when asked for their opinion on the rally. "The market does OK between now and the end of the year," said Gabelli. "It's got room for a little more upside." Cohen stuck to her bullish year-end target for the S&P 500 of 1150 but warned that, "The market looks like a



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staircase. Maybe it will be stuck on this stair for a period of time until fundamentals start to play themselves out.”

Famous contrarian Marc Faber (managing director, Marc Faber, Ltd.) one of the more bearish round table participants at the start of the year, had not changed his tune. “Stocks are overbought right now, and may correct the strong advance they had in the next couple of months...Anyone who buys the S&P 500 around this level might not make any money, or very little money, for the next five years... This is a dangerous rally.”

The most positive of this gloomy bunch was Barton Biggs (founder and chairman, Morgan Stanley Dean Witter Investment Management), a contrarian after our own heart. But while he acknowledged that, “There is a chance the S&P 500 could move up 50% off it’s March bottom,” he hastily added, “But it doesn’t necessarily mean the beginning of a new bull market, or that we’re going to new highs.”

## Downturn Insurance

There is plenty of anecdotal evidence in addition to the *Barron’s* Roundtable to support the thesis that the professionals are skeptical right now; just this morning we spied an article in *The Wall Street Journal* discussing the “grim market conditions” predicted by the majority of investment professionals at an industry gathering in Chicago last Friday (“Pessimism Pervades Industry Session”). And this rising unease is also showing up in the decidedly un-bullish *behavior* of market participants – professional portfolio managers who are going to great lengths to protect their portfolios from a market decline.

Even as the market surged higher from mid-May to mid-June, short interest on the New York Stock Exchange rose, a fairly unusual occurrence and a sign that plenty of market participants are expecting a downturn and are using short positions to hedge their rising stock portfolios. As we pointed out in our March newsletter (“Where Demand Meet Supply”), “Rather than causing markets to fall, short sellers actually help stocks recover by stepping in to buy shares when no one else will... If stock prices rise, shorts can get ‘squeezed,’ a vicious cycle in which short sellers themselves cause prices to rise as they scramble to cover their positions ahead of other shorts.”

Increasing short interest is not what we would expect to see near a market top; indeed, higher short interest levels are more often seen near a bottom, as short sellers pile on during the last stages of a major market decline, then rush to cover as stock prices rally (see chart above). The fact that short interest remains well above average and is continuing to rise tells us that there is still a lot of skepticism about this rally – and a lot of fuel to keep it going.

In addition to rising short interest, protective put options have remained much sought after during the past few months, suggesting that many of those who are long stocks right now feel the need for “insurance” against a market decline. Investors have been accumulating so many puts on the QQQ (the Nasdaq 100 Tracking Stock), that the ratio of outstanding short-term puts to calls has risen steadily to 2.16 on June 20 from 1.73 in mid-May and 1.13 in mid-April. According to Schaeffer’s Investment Research, a ratio of 2.16 is in the *100th percentile*, meaning it is higher than all readings over the past year, even though that period witnessed such terrifying events as the June/July and September/October declines and, of course, the uncertainty leading up to the war with Iraq.

Traders usually buy put options when stocks are already going down, anticipating a continuation in the trend, so put/call ratios typically rise when the market weakens, not when it rallies. But since April, the QQQ open interest put/call ratio has climbed in tandem with price of the underlying shares. This might not indicate outright bearishness, but it does tell us that investors with long positions in technology stocks are becoming increasingly skeptical that the good times can continue for much longer, and after so many false starts, money managers are not taking any chances with their gains. They have been burned too many times for thinking that this time might be “different.”<sup>1</sup>

## Whom Should You Listen To?

It seems clear from both the *Barron’s* Roundtable and the defensive behavior of market participants that professionals are worried that the rally has gotten ahead of itself – a positive sign, since bull markets love to climb a “wall of worry.” But we cannot ignore the fact that so many individuals are expressing optimism for stocks in spite of the damage done during the three-year bear market and the still-pervasive doubts about the economy – based on historical comparisons, this is undeniably dangerous. From the standpoint of a contrarian investors, which of these groups is the most reliable?

Research shows that the correlation between the sentiment of individual investors and that of newsletter writers is strong, whereas the relationship between the Wall Street pros and the other two groups is not. And that is exactly what we are seeing today, as professionals become increasingly skeptical in the face of rising stock prices while newsletter writers and individuals are pounding the table for stocks.

The good news for stock market investors right now is that the negative relationship between the sentiment of Wall Street professionals and future stock market returns is statistically more significant than that of individual investors or newsletter writers. In other

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<sup>1</sup>Source for options data: *Barron’s Online*, June 23, 2003.

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words, if you have to bet that one of the three is wrong, go against the pros.<sup>2</sup>

According to two different studies of the *Investors Intelligence* surveys of newsletter writers, one looking at data from 1964 to 1998, and the other covering 1985 to 1998, it appears as though there is *no* statistically significant relationship between the level of sentiment of newsletter writers and stock market returns in the following 4 weeks, 26 weeks, or 52 weeks. These results suggest that there is little value in using newsletter writer sentiment as part of a contrarian methodology, though we suspect that extreme levels of sentiment may be still be useful when appearing in tandem with the other two groups.

The level of sentiment among individual investors is a more reliable indicator of future stock market returns. Based on AAI data from 1987 (when the survey was first conducted) to 1998, it was found that an increase of 1.0% in the sentiment level of individual investors is associated, on average, with a 0.10% decrease in S&P 500 returns over the following month.

But the strongest inverse correlation between sentiment and stock market returns is found among professionals. Using Merrill Lynch sell-side strategists data from 1985 to 1998, it was shown that an increase of 1.0% in the sentiment level of Wall Street strategists is associated with an average decline of 0.24% in S&P 500 returns in the following month.

## Follow the Money

Interestingly, there is a *positive* (though not statistically significant) relationship between the *actual* stock market allocations in the portfolios of individual investors and future S&P 500 returns, suggesting that higher mutual fund inflows combined with pessimistic professional sentiment might be a positive sign for the market. And that is exactly what we are seeing today. June was on track to see the biggest monthly inflow into equity funds since March 2002, less than one month before the post-9/11 rally failed and the market began its decline to fresh bear-market lows. This follows inflows of \$12 billion and \$16 billion in May and April, respectively.

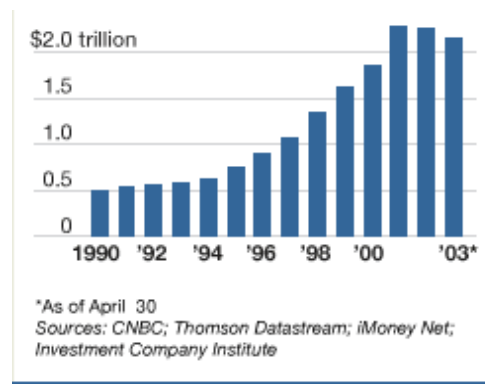
The recent reversal in mutual fund flows may indeed be a good sign for the market if it marks the start of a trend; there is a very large amount of cash sitting on the sidelines, and this is always a necessary ingredient in new bull markets. With interest rates at 45-year lows and money market returns effectively zero, investors have a large incentive to put this cash to work – in stocks, real estate, precious metals, or

any other asset class that appears to offer a better opportunity for meaningful returns.

Should inflows remain steady at these levels, what impact might this have on stocks? Consider that the \$16 billion from May annualized is \$192 billion, in-line with the average annual inflow of \$196 billion seen from 1996 to year-end 2000, a period during which the S&P 500 gained 113% *before* dividends - anyone who sold stocks in 1996 due to the “overly bullish” \$212 billion that flowed into equity funds in 1996 missed out on three more years of tremendous stock market gains.<sup>3</sup>

The bears will point to a recent Merrill Lynch survey of fund managers, showing that they are the most fully invested they've been in two years. Indeed, the current cash position of mutual funds is 5.1%, far lower than the 12.9% seen near the bottom of the last bear market in October of 1990 and a mere 1% higher than the all-time low recorded at the top of the last bull market in March of 2000. But don't be fooled. Rather than implying a lack of available capital to allocate to stocks, the relatively low cash position of mutual funds is a consequence of the enormous amount of money that investors have pulled out of equity mutual funds during the recent bear market. Much of this money has gone into bond funds, a vast pool of available liquidity for the stock market should the recent decline in bond prices accelerate, something that would likely cause money flows to reverse between these two asset classes.

Money Market Fund Assets\*



And bonds certainly aren't the only source of liquidity for the stock market; plenty of cash is sitting in money market accounts earning next to nothing. At the end of April, a whopping 33% of the \$6.49 trillion in mutual funds was invested in money market funds – more than two *trillion* dollars of potential stock market fuel. By way of comparison, money market assets were less than \$500 billion in 1990.

<sup>2</sup>All sentiment and return data on this page is from: Fisher, Kenneth and Meir Statman, “Investor Sentiment and Stock Returns,” *Association for Investment Management and Research*, 2000.

<sup>3</sup>Source for equity fund flows data: TrimTabs.

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## Profits or Prophecy?

Heavy insider selling last May followed by aggressive insider buying at much lower levels later in the summer of 2002 are consistent with a long history of insider trading being on the right side of big market moves, up or down. Within this context, does the broad based selling that we have seen during the past several weeks portend an *imminent* stock market decline?

Probably not. When it comes to analyzing insider transactions, timing is everything. The insiders were right to be bullish last August, but they were also early. Stocks headed south again in September of 2002 and fell to fresh bear-market lows in October. In fact, it wasn't until earlier this month that the S&P 500 finally surpassed its August high – more than nine months after the 8-week sell/buy ratio reached its most bullish levels last fall.

The tendency of insiders to trade well before material information reaches the market is documented in new research by three professors at Pennsylvania State University, to be published in the forthcoming August 2003 issue of the *Journal of Accounting & Economics*.<sup>4</sup> Their study provides evidence that insiders possess *and* trade upon knowledge of specific and economically-significant forthcoming accounting disclosures as far out as two years prior to the disclosure, and insider stock sales accelerate three to nine quarters before a disappointing quarterly earnings report. As one would expect (especially in today's post-Enron regulatory climate), there is very little abnormal selling in the two quarters (6 months) immediately prior to any break in a string of consecutive increases in quarterly earnings. This suggests to us that if the heavy insider selling we are seeing right now is in response to specific and material information, that data may not hit the market until next year.

But another possibility must be considered: After three brutal years of stock market declines, not to mention an extraordinarily volatile ten months following the high levels of insider buying seen last summer, perhaps these executives and directors are simply taking profits. Like professional money managers who think the economy will expand but are nonetheless worried enough to hedge their bets, insiders may be figuring that with earning visibility still poor, now is a great time to take something off the table.

One need not look back too far to find evidence supporting the profit-taking thesis; the last time the United States experienced a prolonged economic

downturn following a stock market bubble was the 1980-1982 recession, and insiders exhibited precisely this sort of behavior as stocks surged in the aftermath of the bear market that accompanied this economic downturn.

What the Internet was to the Nasdaq in early 2000, energy stocks were to the S&P 500 in early 1981. There seemed no end in sight to skyrocketing inflation, and commodity prices were going through the roof. Saddam Hussein had ordered the invasion of Iran in the summer of 1980, and Iraqi military units swept across the Shatt al Arab waterway into the province of Khuzestan – Iran's richest oil-producing area. The price of oil had already reached \$33/barrel by late 1980, following the loss of 2.5 million barrels a day during the 1979 Iranian Revolution, and in 1980, Iraq's production fell 2.7 million barrels a day as a result of the war. From 1978 to 1981, oil prices more than doubled, from \$14 to \$35, and the consensus of the experts was that the price would eventually hit \$100 (see chart on following page).

In the March issue of *fcNOTES* ("Where Demand Meets Supply"), we described how the forces of supply and demand create stock market bubbles: "The price of any category of financial asset is a function of how many people want to own it relative to how much of it there is. During periods of optimism for a given asset, rising demand leads to rising prices, which in turn generate the incentive for producers to create more of it." As would be the case with Internet and telecom 20 years later, by early 1980 demand for energy-related stocks in the United States reached manic levels, and the investment bankers followed the money, as they always do.

Think the Nasdaq bubble was "different?" Think again:

- In 1980, energy-related stocks made up 20% of all IPOs; in 1999, 21% of IPOs were technology-related.
- In 1980, energy stocks represented 28% of the value of the S&P 500; in 1999, 30% of the S&P 500 was technology.
- In 1980, energy stocks rose 83%; in 1999, tech stocks increased 130%.<sup>5</sup>

The energy bubble of 1980 met the same fate as the technology bubble of 1999. From November 1980 until August 1982, the S&P 500 declined more than 26%, but energy stocks were hit much harder, plummeting nearly 50% during the same period. And in spite of continued rising demand since then, energy has been the worst-performing sector in the S&P 500 for the past 23 years.

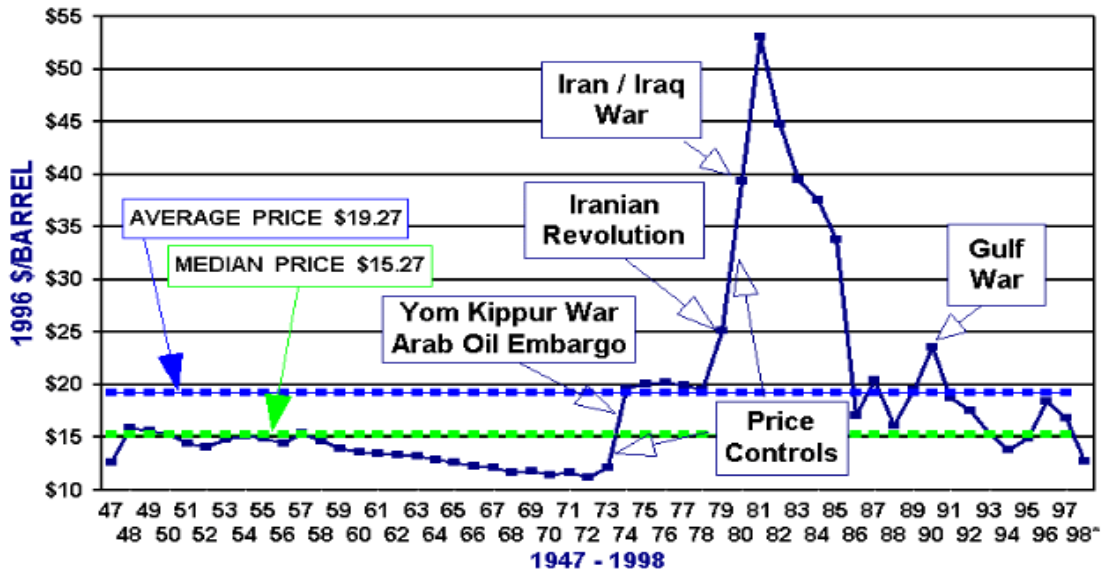
Corporate insiders displayed their usual prescience as the end of the 1980-82 bear market drew near. On March 29, 1982, a little more than four months *before*

<sup>4</sup> Ke, Bin, Steven Huddart, and Kathy Petroni, "What Insiders Know About Future Earnings and How They Use It: Evidence From Insider Trades," Forthcoming, *Journal of Accounting & Economics*, Volume 35, No. 3 (August 2003)

<sup>5</sup> Fisher, Kenneth, "1980 Revisited," *Forbes*, March 6, 2000

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## CRUDE OIL PRICES



stocks bottomed in the first week of August, the Vickers Weekly Insider 8-week sell/buy ratio dropped below 1.0 (see **A** on chart, next page), indicating a high level of optimism among corporate insiders (the normal ratio of selling to buying tends to hover around 2.0, not unusual when you consider that many executives receive part of their compensation in stock).

Once again, the insiders got the big-picture right even if they were a bit early to the party. And what a party it was – from the first week of August 1982 until the end of the year, a period of only five months, the S&P 500 rocketed an astounding 35.6%.

Insider selling quickly picked up as the 1982 stock rally accelerated, and by November 22, the 8-week ratio had hit 4.31 – higher than where it is today (see **B** on chart, next page). And the selling only grew stronger; during the first week of 1983, the sell/buy ratio had risen to an extremely unusual level of five shares sold for every one purchased (see **C**). Surely the end of the rally was near.

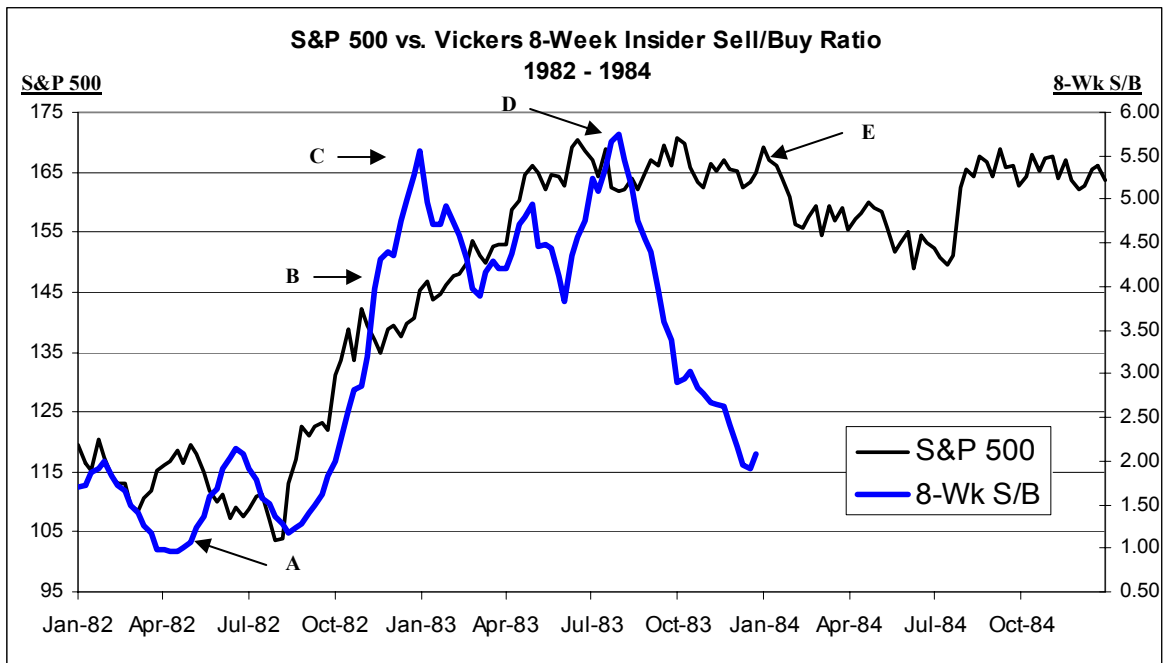
Not by a long shot. During the first *eight* months of 1983, the sell/buy ratio remained at extremely high levels, averaging 4.69 during this period. And for the entire month of July and most of August, the ratio never dropped below 5.00 (see **D**). Yet by the start of 1984, the S&P 500 had risen more than 59% from the bear-market bottom (see **E**).

### Now It Gets Interesting

We cannot deny that the combination of heavy insider selling and bullish individual and newsletter sentiment numbers we are seeing today is disconcerting, given some of the terrible markets that have followed such readings in the past. But a more careful examination of market history puts these apparent negatives in an altogether different context. Professional sentiment is historically a more reliable contrarian indicator than that of individuals or newsletters, and right now the pros are pessimistic. And even if today's insider selling is indicative of real problems, rather than the non-predictive profit taking that was seen during the early stages of the 1982 bull market, it seems likely that a subsequent fall off in stock prices will not be seen for several months. Indeed, the Sarbanes-Oxley Act, which was made law in June of last year, has significantly reduced the filing deadline for insider transactions, meaning that the historic lag time between insider transactions and major market moves may be even longer going forward.

How will we know if we are wrong? We continue to view the 200-day moving average on the major stock market indexes as the most reliable technical confirmation of the longer-term price trend. On April 22, all the major averages were back above their respective 200dmas for the first time since the start of the 2000-2002 bear market. Based on compelling back-testing of the 200dma strategy conducted by

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Wharton professor Jeremy Siegel, we viewed this as a significant technical confirmation of the decision we had made to overweight equities in October of 2002, and we advised our readers to get fully-invested. (Since making this recommendation, the S&P 500 is up more than 6%.)

Also compelling: The percentage of NYSE stocks trading above their 200dmas grew from just 31% on March 12 (the first day of the current rally) to a whopping 88% on June 20. In the past 13 years, this

number has exceeded 80% on only two occasions: early 1991 and the summer of 1997, and in both cases the market posted subsequent multi-year gains.

Should the 200-day moving average fail as support on the major averages in the months ahead, we will move to a defensive posture in our portfolios and will advise you of the specific steps we are taking at that time. But at this juncture, our positive outlook has not changed. Remain fully invested and ride out whatever short-term corrections might occur.

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Please send comments to [fcNOTES@FinanciaCapital.com](mailto:fcNOTES@FinanciaCapital.com)

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**PS** – On May 31, we advised our readers to reduce Treasury bond holdings, and none too soon. On June 25, the Federal Reserve cut its key interest-rate target by 25 basis points, less than the half-point that many traders had hoped for. Treasuries, which had already begun to weaken ahead of the decision, suffered the biggest drop after any monetary-policy easing since 1985. But one bad week does not a bear market make, and we would not be surprised to see bond prices stabilize here and perhaps even move higher over the near term. Longer term, we believe that stocks are the better choice, and we continue to think that the risk of holding a large bond allocation going forward exceeds the potential reward.

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