

At Hand (But Not In Sight)



In the May issue of *fcNOTES* ("Perception Versus Reality," May 31, 2002), we highlighted the *Barron's* 2002 spring Big Money poll, in which 47% of professional money managers surveyed were "bullish" or "very bullish," and the consensus among these self-described bulls was that the Dow would finish the year above 11,000. "We can't think of better reasons to remain bearish," we wrote, adding, "This bear market will most likely end like every other bear market we have had. The *Barron's* Big Money poll will reveal growing pessimism among the professionals as the stock market makes new lows."

We were certainly right about the new lows, and it was thus with great anticipation (and some trepidation) that we opened the October 28 issue of *Barron's* to examine the fall Big Money poll. Given the gut-wrenching decline in stock prices since the spring and deteriorating economic fundamentals, would we find a chastened group of money managers? Or would the pros remain as confident as they were in May, telling us once again (as they have throughout this long bear market) that now is a great time to buy stocks?

On the surface, the results of the poll suggest that professional money managers are still optimistic; 43% of respondents in the fall survey classify themselves as "bullish" or "very bullish," down a bit from 47% in May, but still a large percentage considering the extent to which the economic and geopolitical picture has changed for the worse since the spring.

However, there are plenty of cracks to be found underneath this bullish veneer. The number of professional money managers describing themselves as "bearish" or "very bearish" surged from 17% in May to 28% in the fall survey, a 65% increase. And in sharp contrast to their enthusiasm earlier this year, today's bulls are not expecting significant gains for stocks in the months ahead: on average, they predict that the Dow will end the year at 8583, versus an average prediction in excess of 11,000 only six months ago. With the Dow at 8397 today, 8583 is a timid forecast indeed.

The *Barron's* poll reveals that bullishness is alive and well, at least in name, and many contrarians will interpret this as bearish for stocks. They could be right, and a few more of these bulls may have to throw in the towel before this market finds a bottom. But we would suggest that less important than the type of animal that money managers choose to describe themselves is the substance of their outlook for the future – while there may be plenty of bulls in name, few can contemplate stocks surging anytime soon, and certainly not before the economy and corporate earnings get a lot better.

This belief that fundamentals have to improve in advance of stocks moving higher may sound reasonable, but there is scant evidence to support it. In fact, the market always begins to recover several months *before* the economy bottoms, and the gains during the first twelve months of a new bull market are impressive, especially when the previous bear market has lasted two years or more.

Lead, Don't Follow

In the last nine recessions, the average lead time between the stock market bottom and the beginning of an economic recovery has been 5.1 months (based on data from the National Bureau of Economic Research), and the range has been rather narrow (4 months was the shortest delay between the bottom of the market and the trough in the business cycle). Since World War II, stocks have gained an average of 23.9% between the bottom of a bear market and the resumption of economic expansion, and stock returns have actually risen more *during* recessions in anticipation of economic recovery than they have fallen prior to an economic downturn.¹

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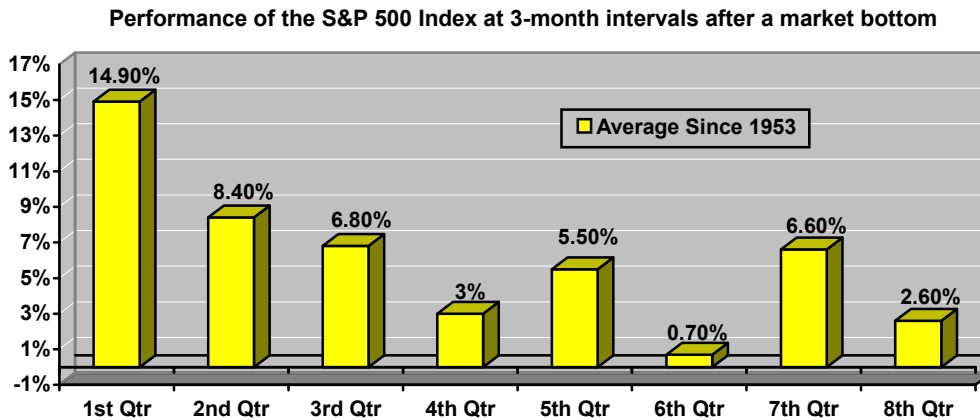
It simply makes no sense to predict stock returns based on today's news, because markets always look ahead by several months, and history has shown almost without exception that neither you nor the experts will be able to find any evidence of improvement in the economy until long after stocks begin a sustained rally. In fact, it is quite possible that economic indicators like manufacturing activity, retail sales, consumer confidence, and unemployment will continue to weaken during the first several months of the new bull market, causing even more bulls to become bears at exactly the wrong time.

In the August 31 issue of *fcNOTES* ("Don't Fear The Fall," August 31, 2002), we challenged the bears "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." We would also challenge them to show us a bear market bottom that occurred after the underlying fundamentals had already started to improve.

History Will Teach Us Nothing?

The historical evidence showing that market recoveries always precede an upturn in the economy by four months or more is a problem for those who insist on being able to see improvement before buying stocks, and that problem is further compounded by the fact that stock market gains tend to be concentrated in the early months of a market recovery.

Research group International Strategy & Investment (ISI) studied 10 recoveries from bear markets, going back to 1953. They found that the average return in the first three months following the end of a bear market is nearly 15%. During the second quarter following the bottom, that average drops to 8.4%. During the third quarter it slips to 6.8%. After that, stock market returns settle into a pace of slower, steadier gains (see chart below), which is ironic when you consider that signs of improving fundamentals are not evident when stocks are posting the best returns.



This data is corroborated by money management firm SEI Investments. They looked at twelve periods since World War II that they classify as bear markets and found that the average return for stocks in the 12 months following the market bottom is 32.5%. Buying only one week after the bottom cuts the average gain to 24.3%. Waiting three months after the bottom knocks the return down to 14.8%.

Think today's market is "different"? Prior to 2000, the U.S. had seen only three multi-year bear markets since the turn of the century: 1929-32, 1939-41, and 1973-74. The returns following the bottom of these bears are even more remarkable, with stock prices increasing nearly 40% on average in the year following the bottom (see table, next page).

Barring a miracle, 2002 will be the third consecutive losing year for U.S. stocks. Only once has the market posted four back-to-back losing years, at the start of the Great Depression from 1929 to 1932, and not only was the last down year the mildest of the four, it was followed by a massive 54% increase

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in 1933. Investors who bought stocks “way too soon,” perhaps at the start of 1932, still enjoyed a gain of more than 40% on their investment within two years. Not bad at all.

Multi-Year U.S. Bear Markets (S&P 500)

1929 -1932		1939 -1941		1973 -1974		2000 -	
1929	-8.4%	1939	-0.4%	1973	-14.7%	2000	-9.1%
1930	-24.9%	1940	-9.8%	1974	-26.5%	2001	-11.9%
1931	-43.3%	1941	-11.6%	1975	+37.2%	2002*	-22.8%
1932	-8.1%	1942	+20.3%			2003	???
1933	+53.9%						

*YTD Oct '02 (does not include dividends)

Data from *International Strategy & Investment (ISI) Portfolio Strategy Report, October 10, 2002*

“The End Was At Hand But Was Not In Sight.” (J.K. Galbraith, describing the peak of stock prices in 1929)

Those who must see proof of an improving economy and a pickup in corporate profits before buying stocks should consider that 1933 was the *worst* part of the Great Depression, as one in four Americans who wanted to work was unable to find a job. Yet the market still rose more than 50% that very same year.

In spite of such evidence to the contrary, most investors believe that underlying conditions have to improve before stocks can perform well again. This misconception is summed up nicely in an article titled “The Bulls May Get Trampled” (contrarians can have a field day with that title!) in the October 28 issue of *BusinessWeek*: “The market could give back the gains of recent days and move mostly sideways for a while. What will turn the tide? Basically, healthy profit numbers that prove to investors, once and for all, that U.S. businesses are in the throes of a genuine recovery.”

In the end, one can always be wrong, and we are certainly not invulnerable to this possibility. But without a crystal ball, an investor has little choice but to look at previous multi-year bear markets (and the years that followed) and ask whether “it’s different this time.” Have the problems that contributed to the most recent bear market created a “New Paradigm” in which stock ownership is just a trap for the unsuspecting? Or, as in every other major bear market in U.S. history, have they created a superb opportunity for those with the guts to think for themselves and ignore the popular emotions and consensus opinions of the moment?

On July 31, we recommended that investors allocate one-third of cash reserves to stocks. In spite of dramatic volatility since then, the NASDAQ is break-even and the S&P 500 is lower by less than 3%. We are now raising our recommended allocation to 60%, with one important caveat: Having just lived through one of the worst bear markets in history, you have an extraordinary opportunity to assess your own tolerance for risk and decide to what extent you can afford to play the odds based on the fact that multi-year bear markets are always followed by big gains. No one can make this decision for you, and the potential for further declines in the near future remains. But we are reminded of the saying that “now is always the most difficult time to invest,” and if the information presented in our monthly newsletters can make your investment decisions somewhat less difficult, we have achieved our goal.

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ⁱ Stock market and business cycle data from: Siegel, Jeremy, *Stocks for the Long Run*, 1998.