

You Decide, They Report

“We trust people who tell us we’re in danger more than people who tell us we’re not in danger.”

-Paul Slovic, professor of psychology, University of Oregon

“Investors have fallen in love with tech stocks like it’s 2000.”

So begins an article by Pablo Galarza titled “Return of ‘Techstasy’” in the November issue of *Money* magazine – just the latest example of what has become a deluge of media coverage devoted to the “reinflating tech bubble.” Like so many others right now, Mr. Galarza fears that investors have forgotten the painful lessons of the late 1990s technology bubble and the brutal three-year bear market that followed, and he advises *Money* readers to “just say no to techstasy.”

But before you rush to sell your technology holdings, consider that this warning is coming from the same Pablo Galarza who recommended *buying* these stocks in early 2000, less than three months before the start of the worst bear market the history of the tech-heavy Nasdaq. “The U.S. economy continues to perform admirably and will likely do so in the foreseeable future,” declared Mr. Galarza in an article he co-authored for the January 2000 issue of *Money*. “To us, this means that considerable opportunity still exists for investors, particularly in those areas that are driving our economic expansion.”

Care to guess the first area of opportunity highlighted by Mr. Galarza and his colleagues in the 2000 *Money* article? You got it – “The march of technology.”

“In the 1990s, technology stocks outpaced the S&P 500’s 400% return by a multiple of three,” wrote Mr. Galarza. “Looking ahead, the build-out of the Internet will propel the sector. Credit Suisse First Boston estimates that we’re just halfway through a cycle of telecom equipment upgrades leading to a global network that will handle data and video as deftly as voice, over phone or cable lines or via wireless devices.”

Oops.

We don’t mean to pick on Mr. Galarza; his bullishness on tech and telecom in early 2000 was shared by nearly every media pundit and market professional at the time, much as his skepticism today reflects the rapidly growing belief that technology stocks have outrun the fundamentals and must therefore come

back to earth soon. But the disparity between what Mr. Galarza was saying then and what he is saying now is as good an illustration as you will find of two things that you must understand about the media to survive and prosper in the stock market: (1) The media consensus is *never* right at real market turning points, and (2) in the wide spaces between the big turning points, most of what you hear in the media is little more than the reverberating echo of what people already believe to be true – and what is therefore already priced into the market.

Wag the Dog

To believe that the danger in tech stocks is real, you first have to believe that the media has uncovered something about which most investors are unaware. In other words, you must believe that the media is capable of predicting an outcome that the market has yet to figure out.

Your odds of winning the lottery are probably better than that.

Nearly two years ago, we advised our readers not to worry about another major terrorist attack on U.S. soil any time soon: “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.” (*fcNOTES*, January 2002)

Media reporting reflects what most people *already* believe to be true, because the best way to sell newspapers and increase television ratings is to play on emotions that are already running high. “Terrorist Attack Imminent!” sells far more newspapers than “Another Day of No Attacks.” The fact that the latter is a more accurate description of the reality – we are in all likelihood safer today than we were on September 10, 2001 – is irrelevant if it doesn’t sell the story.

When the media notices that public opinion is changing, they rush to get out in front of the change so they can appear to be reporting something new. As hedge fund manager Mark Boucher has said so well, the media leads public opinion much in the same way a dog leads its owner on a walk – the dog detects that its master is changing directions and then quickly runs out in front so that it appears to be leading.

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Like a dog “leading” its master, *Money* magazine, CNBC, and every other financial media outlet tries to figure out what the investing public wants to hear and then finds the “experts” and the “facts” needed to construct stories to meet this demand. And when investors read what they have already been thinking, they interpret it as confirmation that what they are thinking is true. The result is a vicious cycle – as people become more convinced and engaged with every new story they see, the media subsequently finds more facts to report and more experts to interview because the story is selling so well.



No emotion creates a better marketing opportunity for the media than does fear, and it is therefore no coincidence that most of what we read or hear about in the news involves the possibility of something killing us prematurely – terrorism, SARS, forest fires, shark attacks, second-hand smoke, etc. The media knows that portraying *risk* is a great way to grab people’s attention and keep it. “It’s much easier to scare than unscare,” points out Paul Slovic, professor of psychology at the University of Oregon. “We trust people who tell us we’re in danger more than people who tell us we’re not in danger.”

Fear is an evolutionary and self-perpetuating survival mechanism – early humans who were quick to recognize fear and translate it into action were more likely to survive and reproduce. “We are hard-wired in our brains to fear first, think second,” says David Ropeik of the Harvard Center for Risk Analysis. And once a person has learned to fear something, he or she will tend to always associate that experience with fear, regardless of whether or not it actually poses a threat in the present.

Having just experienced one of the worst bear markets in history and having suffered from the utter decimation of countless tech stocks, people have come to associate rapidly rising equity prices and high valuations with fear, especially in the technology sector. And like the dog on a leash running out in front of its owner when he or she changes directions, the same media pundits who parroted the conventional wisdom of the “New Economy” in 2000 are now playing on the fear that investors today associate with high priced technology stocks.

Techstasy

Which brings us back to the ominous tone of Pablo Galarza’s November article for *Money* magazine: “Are investors back in ‘techstasy’ – that state of rapture that lets them accept cockamamie growth stories in order to buy stocks with ludicrous valuations?” wonders Mr. Galarza, adding, “It seems that the stock market’s discipline with regard to tech stocks has gone out the window. That’s frightening.”

It sure *sounds* frightening, but is it real? In early 2000, Pablo Galarza and his colleagues at *Money* didn’t fear high valuations at all – they believed that the prices of technology companies were justified by their extraordinary potential. “Tech stocks are dear for a reason,” wrote Mr. Galarza. “Earnings growth in the sector is much faster than that of the market as a whole.”

Today, the Nasdaq is 50% lower than it was in January 2000, when Mr. Galarza and so many others were recommending technology, but you won’t have much luck convincing them that these stocks are a better value

now. Even if an industry-wide recovery is finally here – and Mr. Galarza is skeptical about that – “tech stocks have raced so far out ahead of this nascent revival that the sector is on the verge of being irrationally valued.”

Irrationally valued? Mr. Galarza’s article features a table showing the “high” P/E ratios of several well-known big-cap technology stocks to bolster his case. Picking one familiar name from his list, Cisco’s price-to-earnings ratio today is 33 (based on estimated 2004 earnings), less than twice that of the S&P 500’s P/E of 18. Yet in early 2000 (when Mr. Galarza was recommending tech stocks to *Money* readers) Cisco’s P/E was pushing 150 – more than *five times* higher than the S&P 500’s P/E of 29.

But growth prospects for technology companies were much better in early 2000 than they are today, right? Wrong! The third quarter GDP data released yesterday showed a 15.4% increase in business investment in equipment and software, up from 8.3% in the second quarter. This is nearly identical to the 15.5% increase seen in the first quarter of 2000, when Mr. Galarza and so many others were pounding the table for technology stocks. And as was not the case in early 2000, business inventories are shrinking today, as surprisingly strong demand forces still-cautious companies to tap into existing inventories. In Q3, businesses reduced inventories by \$35.8 billion, which followed a \$17.6 billion decrease in Q2. The combination of falling inventories and rising demand bodes well for stronger production going forward, especially given the backdrop of highly stimulative fiscal policy and a Federal Reserve that is determined to keep interest rates lower than where they otherwise might be as a “firebreak” against deflation.

Even more bullish than the strongest GDP number in nearly 20 years (which, of course, was already priced into the market and helps explain the huge rally in stock prices over the past seven months) is the consensus among economists that growth will be much slower going forward. “The economy certainly won’t keep up the third quarter’s blistering pace in the months ahead,” declares today’s *Wall Street Journal*. Don’t be so sure. As we reminded our readers in

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March of 2002, when economists agree on a likely outcome, you can be certain that something else will happen: "Since the beginning of the year, economists have been celebrating the new conventional wisdom: *the so-called recession never actually happened... but even if it did, don't worry: the recovery is underway...* One thing you can be sure of: they are wrong." (*fcNOTES*, March 31, 2002)

Our readers know that we don't pay much attention to P/E ratios, since valuations have little statistically significant correlation with future stock prices (something few people can comprehend because it defies "common sense"). But the one time that valuations *do* matter is when they are the focus of consensus opinion. In early 2000, few were worried about valuations – the consensus was that high prices were justified by the obviously favorable economic conditions and by the extraordinary growth potential of new technology. The possibility that these high valuations might lead to dramatically lower prices was not priced into the market; what was priced in was the near certainty of spectacularly better earnings.

Today that consensus has been flipped around. Everyone knows that high valuations are dangerous, and thus the downside risk is priced into the market. What isn't priced in is the possibility that future earnings will be far better than anyone can fathom; even bullish analysts admit that at current prices, future gains for these stocks are likely to be modest at best.

Remember, surprises move markets, not what everyone expects, and no one will be surprised to see a decline in "speculative" tech names that have rallied far beyond the broader market averages since October. What will be surprising, however, are high valuations getting even higher, as the market prices in a top-line recovery that few imagine possible.

Going Forward

This month marked the one-year anniversary of the bull market that started in October 2002, and history tells us that the odds strongly favor *at least* one more good year for stocks before the next downturn.

Since the 1920s, the space between negative calendar years in the U.S. stock market has never been less than two years, according to Ibbotson Associates. The shortest positive sequence between negative years for the S&P 500 was the mini bull market between the 1973-74 bear market and an 11% decline in 1977. 1978, 1979, and 1980 were all positive years, followed by a 10% loss in 1981. Then

came eight consecutive positive years (yes, the S&P 500 actually closed higher in 1987 in spite of the October crash), ending with a 7% drop in 1990. And from 1991 until the 2000-02 bear market, the S&P 500 enjoyed one of its best bull runs ever, interrupted only by a small 1.5% decline in 1994.

In last month's issue of *fcNOTES*, we discussed *secular* bear markets, decade-long (or longer) periods in which stocks lose ground. The last secular bear market in the United States started in 1966 and ended in 1982. The Dow Jones Industrial Average finished these 16 years 22% below where it started, and the loss was far worse when adjusted for the rampant inflation of the '70s. While we do *not* believe that stocks will be mired in a secular bear during the next ten years, history provides reassurance for the coming year even if we are wrong; the shortest *cyclical* bull rally within the 1966-82 secular bear market lasted 21 months – a 76% gain from December 6, 1974 to September 21, 1976. By way of comparison, the current bull rally in the S&P 500 is 12 months old and has seen a gain of 35% off the October 2002 lows.

Although the secular bear scenario cannot be ruled out entirely, history has shown that stock market returns following three consecutive below-average calendar years are almost always spectacular. Needless to say, the negative returns of 2000, 2001, and 2002 were far below the long-term historical annual average return of 7% above inflation, and while there will likely be plenty of volatility along the way, we believe that the market will be much higher five years from now than where it is today (see chart).

U.S. Stock Market After Three Below-Average Years

Year	3-Year Return	5-Yr Forward Return	10-Yr Forward Return
1931	-43%	+176%	+86%
1932	-8%	+95%	+144%
1941	-12%	+128%	+393%
1948	+5%	+128%	+523%
1970	+4%	+17%	+125%
1994	+1%	+251%	<i>Pending</i>
Average	+133%	+254%	

Source: Thomson Financial

We will discuss our outlook for 2004 in greater detail in the December issue of *fcNOTES*, and next month we will give you a "report card" on the predictions we made and the advice we gave you this year.

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