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Don’t Jump!
The Great Market Panic of ‘02

By Daniel R. Sharp, Ph.D.

This is the roughest stock market that most investors have ever seen. It comes, not coincidentally, after the greatest stock market bubble that most investors have ever seen. There are strong parallels to both the roaring 20’s and the crash of 1929 as well as the Japanese bubble and its subsequent ten-year bear market. The big difference is that these earlier examples, along with the bear market of 1973-74, had very poor economic conditions – something that we currently do not face. The current bear market and final blow-off panic are the end result of the unwinding of the greatest overvaluation in stocks seen in our lifetime. This is a good thing in that stock prices follow the economy in the long run. Between the valuation correction and a moderately growing economy we can expect a much more reasonable stock market going forward.

The bigger the greed during the bubble, the greater the fear factor when the bubble bursts. Fortunately, fear and greed do not set long-term prices for the stock market, but can and do set short-term prices significantly different than economic reality. It is human nature to pay much more attention to changes in short-term prices, up or down, and ignore economic reality. This is what makes most people such poor investors – it’s in the genes!

During the bear market of the last three years many investors that ignored diversification and valuation found themselves down 60, 70 or 80%. As a result, the last three months have

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Investing in Strange Times

Investors have never faced more uncertainty in regards to their portfolios. Stocks are incredibly scary right now, but bonds, money market funds, and other fixed income investments are paying forty-year low interest rates. Whether you are trying to create wealth, preserve wealth, or derive a living income from your portfolio – it’s a tough time to figure out the correct course of action.

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been a capitulation of investing in equities. Investors have bailed out on all equities, even those with solid financials and low valuations. The average blue-chip stock reported increased profits and sales but still dropped 25% over the past several months. Why? Investors are terrified of risk. The risk of accounting fraud, the risk of overvaluation, and the risk of economic difficulties. But how real are these risks? Ironically, with the NASDAQ down almost 80%, the S&P down nearly 50% and the Dow down more than 35% from their highs, there is much less risk in the markets now than at their peaks. Yet people perceive there to be much more risk and feel that there is no bottom, just as they felt there was no top just a couple of short years ago.

Yes, the aftermath of the market bubble has uncovered some massive corporate fraud and **accounting issues** in a few large companies, but to extrapolate that to all of corporate America is like saying that all residents of a neighborhood are criminals if one person in the neighborhood is a criminal. Corporate reforms and safeguards are necessary, and will be good for America in the long run, but until CEO's start to certify SEC filings (August 14th) there will be a lack of confidence in company numbers. The SEC routinely questions hundreds of companies every year, but now the acknowledgment by management (or even a false rumor) of an inquiry can cut a stock in half. ***Currently there is no difference in investor perception between a routine investigation and the uncovering of massive corporate fraud.*** The accounting issues are just the latest excuse to exhibit fear, just as the energy scares last summer and terrorist attack last fall were. Whatever is dominating the headlines has a strong effect on the investor psyche.

When investors were greedy a few short years ago they seized on many ridiculous ideas (remember the new economy?) to fuel the greedy psyche. **The risk of overvaluation** is still valid in certain sectors of the market but this fear is really only valid in some of the formerly high growth industries that still average 25 times earnings multiples. ***Most of the Dow stocks are now trading at less than ten times earnings but their stock prices have been crushed anyway and really are bargains at current prices.***

The owners of former highflying stocks need to get a reality check on fair valuation and make long-term changes when prices are reasonable – not where they were three years ago. However, if your company was not getting hammered before mid-May and has not developed any operational problems, it should quickly return to pre-panic levels once investors are done throwing out the baby with the bathwater.

The **risk of economic difficulties** grows less with each new data point showing a steadily improving economy. Unemployment is going down. Real estate and consumer spending, fueled by 31-year lows in mortgage rates, remains strong. The Federal Reserve is holding interest rates steady at a four-decade low with no rate hikes in the immediate future***. We have a moderately growing economy recovering from the mildest recession in history. The economic backdrop for stocks is the best that it has been for three years.***

The truth is that the long-term drivers of the stock market, which are interest rates, economic growth, and energy prices, are all in favorable conditions for stocks. Market psychology is a contrarian indicator, and the fact that there is now so much doom and gloom is actually a positive sign that things can and will start to improve soon. The last time the majority of investors agreed about the stock market was in early 2000 when they thought the sky was the limit. They were wrong then, and are wrong now when they think the sky is falling.

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If you are **trying to take an income** from your portfolio, the choices are dismal. Currently, most money market funds pay less than 1%, and investment grade bonds are yielding barely north of 4%. Worse yet, with interest rates at forty year lows the inevitable eventual direction for rates is up – meaning that fixed income investments are going to decline in value as a group over the foreseeable future. Essentially, buying fixed income right now is buying at the top and could be painful in the long-run even if it feels safe to do right now. The risk is like a dripping faucet rather than a burst pipe – nothing to get excited about but costing you a lot of money in the long run.

There are currently three ways to boost yield that should hold up well over time. The first is to **buy high-yield bond funds** (Vanguard has some excellent choices). Corporate defaults have peaked, yields are incredible (over 10%), and the likely direction of prices of high-yield bonds is up as default rates fall over time. It is critical to buy bond funds as opposed to individual high yield bonds to eliminate the risk of any one company defaulting – most bond funds hold hundreds of individual issues of high-yield debt.

The second idea is to **purchase REITs (Real Estate Investment Trusts)**. These trade like a stock but with less risk (they are down less than half that of stocks over the past few months). They yield around 8% and have historical capital gains rates of about 6% over time. REITs are less undervalued than stocks right now so investors have to look for specific opportunities rather than buy the whole sector. You can buy REITs that specialize in all sorts of real estate, medical, government, shopping malls, office complexes, etc.

The last area for yield is just to **buy a portfolio of Dow stocks**. With prices having come down 35% over the past two years, Dow stocks now yield 5% with significant long-term appreciation potential. A portfolio of Dow stocks will obviously have greater short-term price volatility than other sources of income, but the dividend is safe and the long-term appreciation potential is much higher than other fixed income choices.

If income is not a concern, then you are likely either holding stocks or cash, or a combination of both. If you are all in stocks, the best thing you can do is to sit on your hands and do nothing for a while, even if you own a portfolio of busted tech stocks. Even in bear markets there are powerful rallies that should allow you to step out at better prices than during times of panic. No one has ever made long-term money selling into a panic. Set realistic exit goals if you perceive your investments to be temporary (like NASDAQ 1700, etc.). If you are all in stocks but have really only experienced declines over the past several months, you are likely much more diversified and holding reasonably low valuation stocks. Again the best choice is to do nothing as it is extremely likely that prices will rebound quickly in these higher quality stocks when the panic is over.

If you have cash to invest and are committed to a long-term investing program, dollar-cost averaging into the market at this point offers the best combination of prudence and opportunity. A panic or crisis during a bear market often signals the bottom and takes the guesswork out of trying to time the bottom. The average gain twelve months after the bottom of a true bear market is a whopping 73%! This compares with an 8% average gain in the last year of a bull market. Most experienced fundamental investors will inevitably start buying into a bear market too soon, as the bargains become too good to pass up. However, good bargains frequently turn into great bargains in bear markets as investor psychology drives prices below reasonable levels the same way it drives prices above reasonable levels in an aging bull market.

The best thing to do then, when you think that prices can't possibly move any lower, is to

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Value Investing: The purchase of companies, through the stock market, for less than their economic value due to temporary unpopularity (lack of investor demand). This is the opposite of growth investing, which is buying companies at a premium in the hope that other investors continue to push their prices higher and higher regardless of what the business is actually worth.

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spread out your buying program over six months. The next best thing to do is to buy quality high dividend-yielding stocks (wonderfully abundant in bear markets) to tide you through the rest of the bear if you've bought in before the turning point. Other strategies include buying excellent large companies and small capitalization value companies which historically rebound strongly out of bear a market. ***The common thread running through all these techniques is that an investor doesn't have to catch the exact bottom to benefit.***

A 73% rebound is forgiving as long as an investor does some buying within several months of either side of the turning point. The turning point, in retrospect, is invariably that point at which there is the least interest in the stock market, and doom and gloom is strongest.

The beauty of the bear is that like a panic, it doesn't take a genius to pick bargains when the whole market is a bargain. The great Warren Buffett stayed out of the market from 1969 to 1972 because he could find no bargains, but was fully reinvesting during the 1973-74 bear. Everyone hopes to buy stocks near bear market troughs. But many are unprepared for the opportunity, either psychologically or financially. ***The trick is to be fearful when others are greedy, and to be greedy when others are fearful.***

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