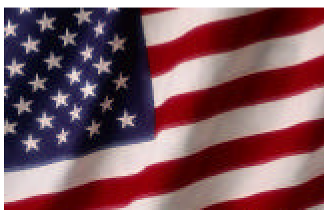

September 24, 2001

Investment Environment after September 11th

The attack on the World Trade Center and the Pentagon occurred on Tuesday, September 11th. The U.S. stock market opened on Monday, September 17th and has traded for five days.

For me, there have been two distinct aspects of this disaster. First, I have sought to deal with my feelings of horror and outrage at this event. I have so clearly felt the pain that other parents must be feeling. It looks to me like many of the victims are young people in their 20's and 30's, i.e. the same approximate ages of many of our kids. Second, we have been assessing the effects on the markets. Our business is built upon the stock market. Our investment focus is optimistic and growth-oriented.

Last week we watched the markets closely. We wanted to see if they were trading efficiently. They did. We wanted to see how individual stocks would fare. Generally, the markets sorted through the stocks as expected, although I was surprised at the selling of the oil stocks.

One of the issues I face as a professional investor is that very few members of the professional investment community have my years of experience. Last week I consulted with some of my oldest and best fellow associates. All of our careers pre-dated the great bear market of 1968-1974; now, that one was a bell-ringer. We have all been through numerous major economic/market crises so that we could offer each other some perspective on the events of the past two weeks. We agreed upon the following:

1) This crisis was huge but not necessarily bigger than other crises we had seen.
2) It is very important to focus our decisions on what we could reasonably know and avoid spending a lot of analytical effort on things we could not know or predict.
3) We could offer our clients little short-term solace regarding the stock market or the economy.
4) This is one of those rare times when the stock market offers exceptional returns to those investors with a reasonable long-term horizon.
5) This is one of those times when patriotism and great investment practices are coincident.

With the previous background in mind, I offer Disciplined Growth Investor's assessment of the current market outlook.

What We Do Not Know

1) We do not know if the September 11th terrorist attacks will tip the economy into a severe recession.
2) We do not know if the stock market has bottomed yet.
3) We do not know if there will be more terrorist attacks in the continental U.S.
4) We do not know the extent of or the aftereffects from the U.S. military response.
5) We do not know what odds to place on each of these events.

Therefore, my staff and I are going to spend as little analytical effort as possible on trying to predict these events.

What We Know

1) The gold, oil and currency markets have been trading within normal bands since the September 11th attack.
2) Monetary policy has turned even more expansive after the attack.
3) Stock market indicators reflect extreme panic selling by stock market participants after the attack.
4) Many stocks sell at the biggest discounts to their intrinsic values since 1998 and 1974.

Gold, Oil, and Currency. The response of the gold, oil, and currency markets since September 11th has been illustrative. Oil prices, as represented by Brent Crude, traded at $27/barrel before the attack, spiked briefly to $30 and now trade at $22.50 today. Gold has increased from $274/ounce to $290/ounce, an increase of 6%. The dollar has depreciated 1-2% against most currencies. None of these important key commodities are suggesting a major crisis. The drop in oil prices bodes very well for the U.S. consumer.

Monetary Policy. Monetary policy can be evaluated by measuring the growth of the monetary base and the level of short-term interest rates. Fed management of the monetary base over the past two years has been highly variable. The Fed exploded the monetary base prior to Y2K and then shrank the base for the next eight months. In forty years of Fed history, the Fed never shrank the base for more than two months in a row. Prior to September 11th the Fed began to grow the base; the Fed has been even more aggressive after the attack. The Fed easing has had a major effect on short-term interest rates. 90-day Treasury Bill rates have fallen from 6.4% to 2.2% in the last nine months. Two-year Treasury notes have fallen from nearly 7% in May of last year to 2.9% today, the lowest yields since 1958. The yield curve is now steeply positive. Low interest rates are lousy for retirees but wonderful for consumers, businesses and stocks.

Investor Behavior. There are many published polls on investor sentiment. I prefer to track actual market activity and I find technical indicators useful at identifying major selling panics. Among the excellent indicator measures is the ARMS Index, a measure of up/down market action versus up/down volume. When down volume expands dramatically relative to the number of down stocks, the Index reflects extreme panic selling. Only sixteen times in the past 38 years has the ARMS Index indicated major panic selling. Three of those extreme readings have occurred in the past six months. The second index is the McClellan Oscillator. The McClellan Oscillator is a breadth-based indicator and measures the relationship between the 40-day average and the 20-day average. It tends to focus on intermediate trends but is useful as a short-term market indicator at extreme readings. The McClellan Oscillator reading on the NASDAQ reflected record bearish selling last week. The third measure is the CBOE put-call ratio. The put-call ratio rose to 121% last week. This is the highest reading in the history of the index and reflects unprecedented fear. It should be noted that the put-call ratio is not only at extreme levels but the 3-week average put-call ratio is over 20% higher than the 39-week average put-call ratio, a level which has been reached in 1987, 1992 and 1998. Two weeks ago the U.S. experienced one of the horrific events in its history; according to market indicators stock market participants reacted by engaging in extreme panic selling last week.

Equity Valuation. The third market element, and most important, is equity valuation. We think it would be helpful if we spend a few sentences explaining what we mean by equity valuation. Let's assume we have conducted extensive research on company A. We have arrived at the conclusion that company A is worth $20 per share without respect to the current price of the stock. If the stock is trading at $20 per share then we would say the stock is fairly valued, i.e.; trading at intrinsic value. If an investor purchased the stock at $20 per share, the investor would participate in the future fundamental progress of the company. Let's say the stock is selling for $10 per share. We would say the stock is undervalued. An investor who paid $10 per share could reasonably expect to enjoy both the narrowing of the discount to the intrinsic value plus the improvement in intrinsic value over time. If the stock is selling at $30 per share we would say the stock is overvalued. An investor who pays $30 per share could expect his stock to depreciate to the intrinsic value plus any fundamental improvement in intrinsic value. It is common for stocks to sell at wide variances to intrinsic value, primarily based on the degree of short-term uncertainty. Over the long run stocks tend to sell at or near their intrinsic values.

Discount To Intrinsic Value. Before the attack we believed we owned stocks offering our clients excellent returns. Since the attack we have been reviewing each of our holdings. We have concluded that our stocks sell, on average, at their biggest discounts to intrinsic value since 1998. To offer additional perspective, in 1998 we asserted, correctly, that at the market bottom that year our stocks sold at the biggest discount to intrinsic value since 1974. Maintaining or increasing current exposure to stocks at today's prices will offer the investor a chance at the highest potential returns in years.

One of the most ironic and enduring characteristics of the stock market is that the lower stock prices fall, the less attractive they are to investors. As short-term uncertainty increases, market participants prefer to increasingly accept safety over return. At market extremes, uncertainty is dazzlingly and ubiquitously high. So, too, is the discount of stock prices to intrinsic company valuations.

Market participants who yearn for more clarity before committing money to stocks get caught in a trap. While it is fun, and somewhat satisfying, to guess at how and when we might smash the terrorist activities, I believe it is not possible to gain a competitive edge by this endeavor. Even the key players in this drama do not know how the battle will unfold. How does one know when the terrorist threat is really reduced? How does an investor know before other investors that the economy is recovering? To complicate matters even further, as uncertainty diminishes, the discount between stock prices and intrinsic value narrows. At what point do we as investors determine that the inflection point between uncertainty and discounted value has been reached?

Those of you who have read this far may note that I have not commented on the current rush for analysts to reduce corporate earnings estimates. Because corporate earnings estimates are falling many market observers assert that this proves that stocks are overvalued. To this I have two responses. Wall Street analysts' earnings estimates are generally coincident with short-term economic trends, i.e.; they fall with short-term uncertainty and rise when the outlook is terrific. Second, short-term earnings estimates as a measure of the value of a company offer a very poor tool to the investor. We at DGI are far more comprehensive in determining what a company is worth.

In subsequent pieces I will begin to examine the likely areas of best performance. As you all know I have been warning for at least three years that the very large cap stocks will not offer attractive returns. If the war on terrorism dampens overall economic growth then our case for small and mid-cap stocks will be even stronger. The small and mid-cap companies will be among those offering the best growth over the next ten years. In thinking about the course of events in the future, my guess is that the uncertainty over future terrorist attacks might recede slowly. This would mean that the discount between stock prices and intrinsic value would narrow slowly, offering investors a nice multi-year period of exceptional returns. This would be a nice contrast to the hyper-extended market action after the 1998 bear market which ended in a boom-bust cycle for technology stocks and internet IPO's.

My investment thoughts are not meant to minimize the threat posed by the attacks on September 11th. This is a pivotal event in the history of the U.S. and perhaps the defining event for my generation, the baby boomers. (The next generation will have its own defining event.) President Bush got it right when he stated that this war is about freedom versus fear and about whether our society or the Afghan society will be the model of the future. If we reduce terrorism to acceptable levels, then the world will enjoy a level of prosperity that became achievable with the end of the Cold War.

In many ways this war will be different from others, yet the same. Each of us must conduct our own affairs by putting ourselves at some risk to another terrorist attack. Each of us must act with courage and prudence. Such behavior, if maintained, will enhance our chances for victory. If we succeed in reducing the threat of terrorism to acceptable levels, our children will have a chance at unparalleled prosperity and freedom and their own defining moment.

For my part, my commitment is to put aside my own fears and doubts and lead my associates so that we coldly represent your financial interests.

In summary, please contrast our crisp assessment of the current market conditions and the extreme discounted price of stocks with the amorphous discipline that says market participants must wait until the fog lifts. Today, the stock markets offer the highest, sustainable returns I have seen in at least twenty years. This is proper, in order to compensate investors for the high short-term uncertainty. In contrast, the fixed income markets offer the lowest expected returns in at least twenty years.

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