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Our love affair with stocks: Are we about to be jilted?

by Allen Elstein

The time was 1995. The Dow Jones had just reached 4700. A number of technical analysts had gotten out their super calculators and determined that the stock market had moved too far, too fast. A minimum of a 10% correction was needed to wring out the excess.

Fast forward to February 1996. A legendary mutual fund manager troops out that prediction and points out that anyone who stayed out of the market waiting for a 10% correction would have missed out on the run up between 4700 to 5600. Score one for the pros that say that the market is too unpredictable; the long-term investor should always be fully invested.

The argument about the invincibility of stocks is the same one we have heard for home ownership and, before that, for investing in rare older United States stamps: mainly, that as long-term investments, good gains are virtually guaranteed. Certainly, the stock performance and the U.S. economy have outlived most of the doomsday books about the coming depression or the coming mutual fund crisis — or have they?

It can be argued that we are in an era of stock speculation. Speculation does not mean that prices go down, or that prices will not dramatically go up even more. After the price of a Boston condominium doubled in four short years, the experts pointed out that prices were so high that renting and waiting for a fall in prices was the obvious strategy. The public, flush with money from two family incomes and the Massachusetts miracle, did not listen. Prices went up another 30%. The $70,000 condominium was now worth $180,000. Unfortunately, two years later, it was worth $100,000.

One does not have to look to houses or rare stamps, where at one time investors outnumbered collectors. The recent history of the Japanese stock market gives some clues. Japan was a country with a high savings rate. Where could the money go? Price to earnings values and price to book values soared. When outsiders questioned this in the 1980s, the Japanese experts stated that Japanese accounting was very conservative, that real value was embedded in the prices, and that in any case, a new paradigm was in effect. Old measures were of no value. The Japanese stock market crashed, nonetheless. One also does not have to look to Japan. The mutual fund industry of 1968-1972 had money pouring in much like today. There were the nifty fifty, growth stocks, and even the go-go funds. The result was huge run-ups that went on much further than the doomsayers thought possible. Unfortunately, when the crash came, many latecomers to mutual funds had lost 40%. Dollar averaging, while it worked for some, failed for others and was abandoned by many, often at the

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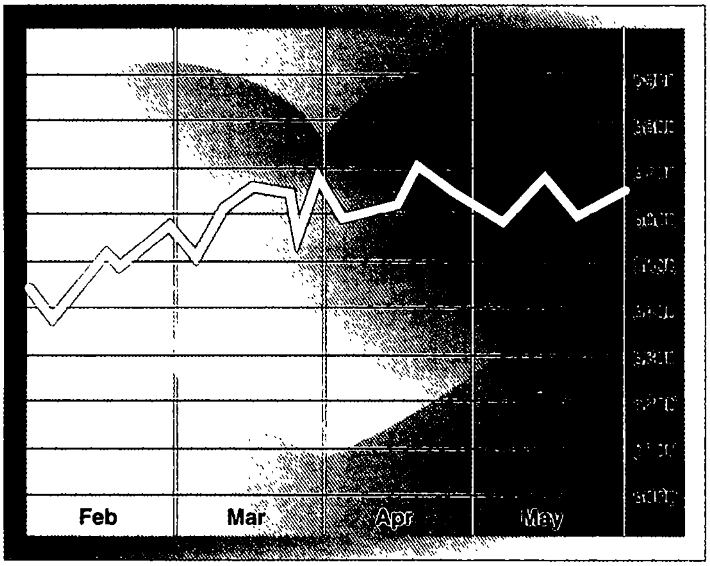
wrong time. Despite good future promise, growth stocks had become too expensive for the pyramid scheme to continue.

It could be argued that the 1968-1972 period was an anomaly that would be buried if a long-term perspective were taken. But were you aware that the 870 level that the Dow reached in 1964 was the same level seen in 1981? To be sure, stock investors who put their money into the market in 1964 and left it there did well, but their long run was 20 years, even when dividends are considered.

What does all of this mean in today's world? There have been a lot of paper winners in the stock and mutual fund markets. Many believe that they have found the Holy Grail. Never mind that a widget factory is only worth the widgets it sells; its stock value has gone up 30%. More generally, did the underlying value of American business really go up last year? Did the decline in interest rates really make future stock dividends so much more valuable? Did downsizing and reengineering really get rid of overpaid employees with the wrong skills and seamlessly substitute a more cost-efficient combination of trained workers and technology? Did the accountants see real gains or a fronting of profits when assets — human and business — were sold and recombined?

Stocks are a hot commodity. Insurance companies are getting into the act by rapidly adding mutual funds to their products, often managed by third parties with little ongoing oversight by the company. Mutual fund prospectuses give broad powers to the fund. Fund managers often go out on the risk curve to make the "top quartile." Who can blame them when recognition and bonuses are based on very recent relative performance. Mutual fund expense levels are going up when economies of scale suggest they should go down. Rollover ratios are often over 100%, where formerly they were under 50%. Some small company funds are so large that they cannot effectively invest in small companies. What would a visitor from another planet say?



Stocks are being touted as a major part of the solution to Social Security. However, no one is pointing out that with the growth of 401(k)s and the decline of defined pension plans, we are already seeing a shift away from retirement guarantees. The fortunes of retirees could all be riding the same roller coaster at the same time if the retirement strategy of many retirees is concentrated in the same set of volatile assets. Betting the ranch takes on a whole new meaning.

The long run needs to be considered. It takes no genius to recognize that if Social Security is partially privatized and $400 billion of extra cash is chasing the same stocks as now, stock prices in the early years of such a program will have a strong upward bias, as has happened in part in Chile. But at some point, the world stabilizes. In fixing the Social Security underfunding, it is important that we not forget that Social Security guarantees a definite amount of income. It is not the time to place too heavy a bet on stocks that are today's darlings but were so cursed not so long ago that half of a generation of stock brokers left the profession. It may be better to moderately reduce Social Security's promises than to aggressively try to make up the shortfall.

As George Santanya stated, "Those who cannot remember the past are condemned to repeat it." However, the lessons of history, under the myopic circumstances of living one day at a time, are difficult to see. Are we in a period where it is wise to "look before you leap," or are we in a period where "the one who hesitates is lost"? It's hard to tell. And if one could, maybe tomorrow would be different. In such a world, where growth is more glamourous than slow and steady, it may be time for actuaries to get back to the basics of managing risk and testing the outer limits of plausible events.

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