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INVESTMENT
ADVISORS
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21Maritime Drive
Manitowoc, WI
54220-4624

www.access-advisors.com

920.683.9901
toll free
888.426.8426
fax
920.332.0004

Crisis of Confidence

I wanted to write you again on the heels of my last letter after having spent 10 hours last week listening to talk radio on my way to meetings in Minnesota. I must have heard the word "crisis" mentioned 50 times in reference to the current state of the stock market. This kind of lazy, sloppy journalism makes me angry. I think the word crisis should be reserved for events like airplanes being flown into buildings killing thousands of innocent people, not for a drop in share prices.

In the meetings I attended we spent a great deal of time bringing some historical perspective to the current situation. Some of the more interesting statistics were reported by Dalbar, a research company focused on individual investor behavior. They compared the performance of the stock market (as measured by the Standard and Poor's 500) to the return that was achieved by the individual investor. From 1984 through 2000 the S&P 500 returned on average 16.3% per year. The individual investor, however, received 5.3% return for the same time period. How can this be? To get the better rate of return, an investor needed to be invested for the full period. History has shown though that the individual investor, who theoretically subscribes to the tenet "buy low and sell high", has a penchant for just the opposite. A case in point; the highest month of cash inflows to stock mutual funds was March 2000, the market peak. The month of the highest outflows ever recorded from stock mutual funds was September of 2001, which was, up until last week, the lowest the market had been since its peak.

Today's (July 22nd) Wall Street Journal reported in the *Money and Investing* section about a 53 year old teacher who had "given up on stocks" after being counseled by his brother (a stockbroker) that there was potential that the Dow could drop another 500 points. This is after he sat by and watched, according to his own account, the value of his retirement plan drop 67%. What? Let me get this straight, this guy is unwilling to let the market drop another 5% after he's already watched two thirds of the value of his portfolio melt away. He is now ready to reallocate his money into bonds when they are expensive relative to stocks. The question that should have been asked by the reporter is why 100% of his retirement portfolio was allocated (I'm assuming at his brothers recommendation) to technology stocks when he was 53 years old and two years away from his planned retirement.

The same section of the Wall Street Journal reported that the PIMCO Total Return Fund (a bond fund) is about to replace the Fidelity Magellan Fund (a stock fund) as the world's largest mutual fund. Knowing what we know about the market-timing prowess of the average investor, what does this tell us?

As of market's close on Friday July 19th, the price/earnings or P/E ratio for the S&P 500 was 16, meaning that you have to pay about 16 times the earnings per share to buy the average stock. At the market peak this number approached 25 (this number is like golf scores, lower is better). The S&P 500 represents some of the most expensive stocks because of the way

the index is built, so I suspect that the average U.S. stock has a P/E ratio south of this number, probably closer to 15 or 14. The stock market historically runs somewhere between 12 and 18. The current "P/E" (yield inverted rate) for 10-year treasury bills is 22. If you own a 15-year bond and rates move up 1% the price of that bond drops 20%. Given that we are at 40 year lows in most interest rates, there appears to be a greater probability that rates will rise, not fall in the future, yet the pricing of bonds seems to indicate the opposite. The average investor is now selling out of relatively cheap securities to buy the relatively expensive ones.

But, what about these scandals? I was talking to my beautiful wife, Kris, last week asking her opinion about why the market had just dropped 400 points. She cited the recent corporate accounting fraud as the primary reason. Good answer. I asked her to name ten companies that had been fooling with the numbers. She did well; she came up with six. A month ago we were led to believe by the media that the majority of Catholic priests were molesters (the number appears closer to 2%). Now we are told that all corporate chieftains are crooks. Maybe the number is 5% (although I think this is extremely high), but that leaves 95% of industry with ethical, hard working CEO's who make money the old fashion way – without accountants.

There is a disconnect between corporate America and the stocks that represent it. The media reports the 6% unemployment figure, not the 94% employed. They report the corporate misconduct of a small handful of corporations, not the majority that are honest. A lot is made about corporations that miss earnings targets, but little is being said about the majority that are hitting their projections. A great deal of time is spent talking about the media bias, but most of this is lost talking about left wing, right wing nonsense when the real bias is much more pervasive. It is the bias to sell their product. Train wrecks sell airtime.

There is a crisis of confidence alright, but for me it's not in the financial markets. It's in those that report on them.