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Article Background

This essay was originally published in April, 2000 newsletter, just days before the tech stock crash began.

Chris Horan Essays

One of the enjoyable parts of my job is I get to write a short essay for this newsletter. To make the essays most useful to you, I try to address critical investment strategy issues in what I hope is a thought provoking way.

Please feel comfortable calling me to discuss the issues or to suggest a future topic.

This issue's essay discusses the phenomenal dominance of the market indexes by technology stocks. It's on the back cover.

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Bear in a Bubble

In my last essay I wrote about 'Bad Breadth', which is when a very narrow group of stocks advances in price while the broad majority of stocks do not. In this essay we'll look at a bear market, which is defined as occurring when stocks decline by more than 20%. (Less than 20% is just a 'correction').

As at 15 March 2000, the breadth in the markets has deteriorated to the point where the majority of stocks are in bear market, even while the tech stock rampage continues.

Consider these facts:
Three out of four stocks in the S&P 500 are now down 20% or more from their 52 week highs, and the average decline is 32%, as reported in the Globe on March 10.

Even the tech-heavy Nasdaq index, which has more than doubled in 12 months, is not all healthy either. Over 61% of Nasdaq stocks are down 20% or more, with the average stock decline of 29%, according to the Wall Street Journal.

The Bank of Montreal, which is representative of the Canadian banks, is down about 45% in 18 months. It isn't just banks. Canadian dividend funds, which tend to invest in the bluest chip, dividend-paying companies (including the flying BCE) have an average two year return to December 1999 of zero.

These are bear market declines.

Meanwhile, as the blue chips sag, a few of the techs still soar, driven by individual investors pouring money into technology mutual funds. Last year, about two thirds of the $185 billion net cash inflow to equity mutual funds in the entire US went to just two fund companies, Vanguard and Janus, according to Morningstar, a fund monitor. Vanguard replicated the tech-driven index, and Janus' biggest holdings are tech stocks. The technology stocks are at valuations never before seen in all of investment history.

In other words, within the tech stock bubble lies a real bear market.

Even some tech experts are concerned, The Economist reports that Mary Meeker, Morgan Staley's tech stock IPO specialist, said recently that 70% of the publicly listed internet companies "will never make money" and that 90% are "fully priced" (which is analyst-speak for "way overpriced").

Will the markets crash? We cannot predict the future. What we do know is that in all previous examples of market euphoria, reality eventually prevails. We also know that in a market downturn, the high fliers fall the farthest. So we proceed with caution.

What's the good news?

We are encouraged by the fact that the market euphoria is contained to an extremely narrow segment of the overall market, leaving many stocks at valuations far below the market averages, and at reasonable valuations by historical norms. Small company stocks in particular (profitable ones that sell things, not e-commerce ones with losses) have excellent growth rates, are quite profitable, and sell at bargain prices.

As Mark Holowesko, manager of the Templeton Growth Fund points out, 'dozens of companies sell at prices 50% below their peaks, with reasonable growth prospects and valuations'.

Remember the 'buy low, sell high' rule?

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