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The Mighty Are Fallen

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Article Background

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Referrals

The primary way my business grows is when clients and business associates refer their family and friends to me. I am very grateful to be directly responsible for a little over $50 million, on behalf of about 180 families. It is a privilege to manage your assets – thank you very much

If you know someone who might be interested in receiving my newsletter, just call or email my office and we'll be pleased to put them on the list.

As we sit quietly somewhere reading this essay in the summer of 2001, we can reflect back on the landmarks of the past year or two. The thread begins in late 1999 when the markets, and the tech-heavy NASDAQ in particular, began to rise strongly. The reason? The markets were correctly sensing that the so-called "Y2K Problem" a.k.a. the "Panic du Jour" was not a problem at all (panics du jour never are, but I digress). The NASDAQ went through 3000 on its way to reach 5000 only 3 months later in one of the most spectacular speculative binges of all time.

Readers of my newsletters know very well that my view of the high P/E stocks in general and tech markets in particular was extremely skeptical to say the least. My clients also know that it was difficult to watch, or listen, as everybody seemed to be making millions but us, because our value-style portfolios were producing low returns. It seemed that everyone else was yakking about how much money they'd "made".

The crash of the technology stocks is staggering. The NASDAQ index fell from over 5000 in March 2000 to about 1700 at its April 2001 low, a decline of 65%. It has since recovered to about the 2000 range (as of June 15) making the decline about 60%. That's right: a dollar invested in the index in March 2000 is now worth 40 cents. The NASDAQ decline has led a decline of tech and high P/E stocks worldwide. The S&P 500 Index, which is strongly influenced by big companies sporting high P/E ratios, has fallen about 26% in the period.

Consider that, according to the Economist, a financial newspaper, the decline of world markets (led by the NASDAQ) represents paper losses of about US$10 trillion. How much is US$10 trillion? It's about 30% of world GDP (the value of all goods & services produced worldwide in a year). It's also about the same as the annual GDP of the entire United States. Roll that around in your mind a bit – the dollar value of all economic production of every working person in the United States for an entire year has just been lopped off of investors' accounts.

Even the icons of the new economy, Cisco, Lucent, Nortel, and JDS Uniphase, have been crushed. People bought these stocks on the assumption that they would have profit growth of 60% per year for at least the next 7 years. Newspaper reporters like Johnathan Chevreau wrote articles about Nortel being a stock you should "hold forever" because it had an established record of "steadily increasing profits and dividend". Sad to say, Chevreau had his facts wrong. Nortel, for example, has not had a net profit since 1998.

Although the share prices of these four companies have recovered somewhat since the recent lows, as of early June 2001 they have fallen on average by 77%. That's right. On average the shares are worth less than one quarter of their peak price. Collectively, the decline in market value of these 4 companies alone is a loss of US$791 billion or C$1.2 trillion.

But, I am pleased to say, not all investors have suffered: in the midst of the carnage in the tech and growth-type stocks, the value stocks have done quite well. In fact, the main North American equity managers that I use for my clients were up on average 23% in 2000 (and 16% to April 2001). To be fair, the non-American managers didn't do so well with an average 12 month – 2% in 2000 (+2% to April 2001). So most of my portfolios have had returns between +2% and +12% for the 12 months to March 2001.

Book Review

I've always wanted to have a book review column, because I love books and I love writing. Since this is my own newsletter, I get to have a book review column.

"Stocks for the long Run". By Professor Jeremy Siegel (Wharton) has been widely quoted in support of the thesis that stocks are the best long-term investment, because their long term returns are highest.

Siegel devotes a chapter to defending the "Nifty Fifty", a group of very popular go-go growth stocks, whose prices were bid to spectacular heights in the early '70's because speculators believed the prices would grow to the sky (sounds familiar?).

As it turned out, the great bear market of '73 – '74 smashed the prices of these stocks, in many cases to one-tenth their highs (sounds familiar?). It took many years for the prices to recover, and some (Xerox, Polaroid, and Emery) have never recovered.

Siegel argues that it was logical for investors to pay the outrageous peak prices for the Nifty Fifty because the return from those stocks as a group equaled the total return from the broad market from 1972 to 1997. In other words a portfolio of the Nifty Fifty stocks bought at the peak in 1972 would have fallen further, but caught back up to the broad market (S&P 500), if is was held until June 1997.

Only problem is, there isn't an investor on the planet who, having bought the Nifty Fifty stocks at the peak in 1972, would have held on for 25 years until 1997, just to catch up.

Siegel makes the mistake common to many academics who don't live with the responsibility of actually managing client's money: he ignores reality. Far better to avoid the bubble in the first place.

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Company Name	US$ stock price High	US$ stock price Current
JDS Uniphase	$140	$20
Cisco Systems	80	20
Lucent Tech	75	10
Nortel Networks	85	15
Microsoft	120	40
Dell	60	25
The lesser names are worse:		
Yahoo	$225	$21
360 Networks	21	2
Amazon	105	15
Ariba	175	6
Linux	200	4

Source: Big Charts via Internet

Where to now for the tech stocks? I wish I could say that they'd recover quickly, but I can't. The reason is that a sharp recovery generally only happens when the decline was from established price levels. In this case, the tech stock boom came and went in less than 18 months. Tom Sassi, manager of the Optima US Value Equity pool, said in a recent conference call, "Never has a sector of the market which has led the market like technology has, ever recovered (from a crash) to lead the market again". Never.

The technology story is more likely to be in the same camp as gold bullion in 1979 (now less than 1/3 the price) or the Japanese stock bubble of 1989 (now less than 1/3 the price), or the Ontario real estate bubble of the 1990's (10 years to recover). That is, if you bought at the top, you could be under water for a long time. So it may be awhile before Nortel gets back to C$120.

But do I think investors should avoid technology stocks? Not necessarily. Why? Tech stocks have merely gone back to where they were in 1998, before the bubble started. So you could say that the tech markets are back to normal and begin to buy them. Unfortunately, for technical reason which space doesn't allow here, there is a huge hangover from the tech stock crash which could keep the lid on prices for a few years.

My advice is that investors who really want technology stocks can begin to accumulate them over the next few years. But there's no rush. A monthly purchase plan is best. Be selective. Use a money manager who can avoid the duds and select the good ones. Chances are, in 10 years you'll look back and see a decent return.

The future of Technology is awesome. Ten years ago we could hardly get good computer printers, never mind send a fax from a laptop. Five years ago we couldn't imagine voice-activated phones. The human genome project promises huge leaps in medicine.

Here's the thing. Science, which is what technology is, will bring us benefits that are so wonderful we can't imagine them. The benefits will be realized all over the economy, not just in the "tech sector". So you don't need to have your investments in tech stocks to benefit from the broad economic growth that the future will bring. A diversified portfolio of profitable companies acquired at reasonable prices should do the trick.

To summarize, we are at the end of the chapter on tech bubble. Tech stocks, like all others, have to generate profits to earn their keep in portfolios. They have to do it at a reasonable price too. The chance that tech stocks will bounce back to glory is low, but there's reason to expect normal returns (and volatility) from here. So, growth investors can carry on accumulating them if they want, in modest amounts. Value investing is back, and will remain, as it has been, the core choice for serious investors.

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