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Déjà Vu All Over Again?

Recent theory about the valuation of common stocks, especially those presumed linked mainly to activity in "The New Economy," bears an uncanny resemblance to the "New Era" notions that propelled the ill-fated stock market boom of 1927-1929. Indeed, streetwise lore holds that such ideas surface mainly at or near market tops.

To students of mass psychology, one of the more enduring types of human conduct is known as herd behavior. In political science, it may be described as the bandwagon effect; in social philosophy as *zeitgeist* (or some other arcane term); and in financial market parlance as momentum, or simply "the big Mo." When people discern a behavioral trend of almost any sort—especially if it becomes sufficiently pronounced—they tend to want to join the party.

Of course, herd behavior, which in nonhuman populations is a survival strategy, sometimes can have unfortunate consequences, as in, say, the lemming effect. The centralized behavior that may reduce risks to individuals within the herd in some circumstances (i.e., with so many other targets in the herd, the lion probably won't get *you*) may doom the entire herd in others (as when fire, flood, or disease vanquish clustered populations). Even so, the notion that there is safety in numbers or, that, if everybody is doing it, whatever "it" is can't be too hazardous, seems an extraordinarily persistent way of thinking. Throughout human history, it has been a powerful source of a wide variety of divergent developments. At bottom, it would appear to have grounded such twentieth-century catastrophes as fascism, socialism, and communism—as well as the counterculture movements of the 1960s and the current environmentalist movement.

Perhaps one of the most intriguing questions is what tends to sustain the herd mentality even when, in view of prior experience, its hazards should be apparent. An adequate answer for all times and circumstances is clearly beyond the reach of this brief discussion. But in modern times, at least, it often has depended on the rejection of prevailing knowledge in favor of some new model. ("Scientific" socialism, which embraced any variety of unconventional analytic notions, yielded the prescription for creating the socialist "new" man; the sixties counterculture and today's enviroculture both are described by the term "New Age.") What such behavior seems to have in common is the claim that older ways of viewing circumstances no longer pertain—and that the new analysis prescribes what under conventional rules would be deemed unwarranted action.

Herd On the Street

And so to the current stock market. Readers of these *Reports* know that for some time we have noted that market valuations of common stocks have been markedly high in relation to most empirical measures used in security analysis—cash flow, book value, earnings, etc. We also have observed that the current bull market is of unprecedented duration and magnitude, and that at some point a genuine bear market or even crash can be expected. In our view, a market strategy based on long-term investments in securities that historically have performed well in down markets and beat average returns over the long run offers the soundest prospects, especially in these circumstances (see our booklet *How to Invest Wisely* for a description of such a strategy).

It is well known, however, that stockbrokers and financial analysts rank highly among those humans prone to herd behavior—and are generally critical of long-term investors. As John Maynard Keynes observed in *The General Theory*, "[I]t is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." It goes without saying that Wall Street tends to welcome enthusiastically any intelligence that might be used to sustain the herd's direction.

Dow 36,000?

Indeed, despite the historically high market values of most stocks and the even more inflated prices of some high-flying internet issues, it is difficult today to find a broker or financial analyst who subscribes to a genuinely long-term investment program. The herd has long described such investors in mildly pejorative fashion, and implied that these "conservative" or "defensive" investors are missing out on the party.

Even with the current jittery market, such investors today are said by some to be not only contrarian, but fundamentally wrong about the way they view the market. For it is now asserted that conventional market analysis is deeply flawed—and that *a new paradigm is needed to measure what ought to be the proper level of stock prices* in the New Economy.

This latter view is perhaps best represented by James K. Glassman and Kevin A. Hassett in their recently published bestseller *Dow 36,000*, which proposes "a radically new way to determine what stocks are really worth."* According to this new analysis, the "perfectly reasonable price" (PRP) of stocks today, if applied to the stocks comprising the Dow Jones Industrial Average, would price the DJIA at the 36,000 level rather than at the current 10,000 or so. To their credit, they eschew short-term trading in favor of long-term investment (which makes them somewhat "contrarian"); they also reject, however, many tenets of conventional securities analysis that have been deemed useful in favor of hypothetical projections

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* James K. Glassman and Kevin A. Hassett, *Dow 36,000: the New Strategy for Profiting from the Coming Rise in the Stock Market*, New York, Random House, 1999, 294 pp., $25.00 (hardcover).

that extend far into the future. But let them speak for themselves:

> Certainly, viewed from a conventional perspective, stocks seem far too high....[But the] problem is that the experts have been making this case for years, and stocks have kept rising. The idea that a historic P/E ratio acts as a ceiling on stock prices is nonsense if stocks have perenially been undervalued....
>
> To know whether the stock market is too high or too low, we need to discover what we call the 'perfectly reasonable price' (or PRP) of stocks. The PRP is the price a sensible investor with a long time horizon should be willing to pay....
>
> So one way to *think of a stock is as a bond with a really, really far-off maturity*, similar to those Disney century bonds. While no stock will last forever, a strategy of keeping your funds in the market as a whole through a mutual fund can be sustained for quite a long time. Extending the maturity toward a far-off horizon actually makes our analysis easier since *we can ignore the repayment of your original invesment and focus only on the cash flow* [emphasis added]....
>
> Now, suppose the government decided to offer a bond that lasted forever—something called a perpetuity. If the interest rate on this bond were constant over time, then it would be easy to price—just like current long-term Treasuries....
>
> Now, let's bring…mathematical calculations...to the world of stocks:
>
> - First, think of a stock as being the same thing as a growth bond.
> - Second, think of a stock's dividend yield as being the same thing as the growth bond's interest rate.
> - Third, think of the growth rate of the stock's annual dividend as the same thing as the growth rate of the growth bond's annual interest payment.

Thus, to calculate their "perfectly reasonable price" for any stock or group of stocks, Glassman and Hassett "need only look at three things: the interest rate on long-term Treasury bonds, the dividend yield on stocks, and the expected long-term growth rate of those dividends." The first two are "easy to find in any newspaper." The third, they say, is "easy to discover"—a heroic assumption given that their "expected" growth rate extends many years, indeed indefinitely, into the future.

Be that as it may, when all assumptions about future streams of income are taken into account, they arrive at a somewhat startling (in view of actual current market prices of stocks) conclusion. "After weighing the historical evidence," they assert, the perfectly reasonable price for the entire market "should be at least three times as high as it is now."

The "New Era" Theory of the 1920s

That this method of determining stock valuations is said to be "radically new" (as it is on the book's cover) simply reveals the extent of today's ignorance of things past. In actuality, it bears an uncanny resemblance to the "New Era" financial analysis that propelled the ill-fated stock market boom of 1927-1929. Fortunately for today's reader, McGraw-Hill's 1997 reprint of the classic 1934 edition of Benjamin Graham and David Dodd, *Security Analysis*, which contains a postmortem on the results then of such "new" analysis, is available as an antidote.* Graham and Dodd's critique serves as well today as it did in the 1930's, and is worth citing at some length:

> We thus see that investment in common stocks was formerly based upon the threefold concept of: (1) a suitable and established dividend return; (2) a stable and adequate earnings record; and (3) a satisfactory backing of tangible assets. Each of these three elements could be made the subject of careful analytical study viewing the issue both by itself and in comparison with others of its class. Common-stock commitments motivated by any other viewpoint were characterized as speculative, and it was not expected that they should be justified by a serious analysis….
>
> During the postwar period, and particularly during the latter stage of the bull market culminating in 1929, the public acquired a completely different attitude towards the investment merits of common stocks. Two of the three elements above stated lost nearly all of their significance and the third, the earnings record, took on an entirely novel complexion. The new theory or principle may be summed up in the sentence: "The value of a common stock depends entirely upon what it will earn in the future."
>
> From this dictum the following corollaries were drawn:
>
> 1. That the dividend rate should have slight bearing upon the value.
> 2. That since no relationship apparently existed between assets and earning power, the asset value was entirely devoid of importance.
> 3. That past earnings were significant only to the extent that they indicated what changes in the earnings were likely to take place in the future.

A crucial, if somewhat subtle, distinction is that although Glassman and Hassett employ dividend rates in their calculation of the PRP, those rates are *presumed future rates* of growth. They resemble not so much the "established" dividends used in the "threefold concept" of analysis described by Graham and Dodd as the changes that New Era Theory presumed would take place in future income described in (3.) immediately above. The calculation of the PRP completely ignores "the repayment of your original investment" as implied by the second point above. Graham and Dodd continued:

> This complete revolution in the philosophy of common-stock investment took place virtually without realization by the stock-buying public and with only the most superficial recognition by financial observers. An effort must be made to reach a thorough comprehension of what this changed viewpoint really signifies. To do so we must consider it from three angles, its causes, its consequences, and its logical validity.
>
> Why did the *investing* public turn its attention from dividends, from asset values, and from earnings, to transfer it almost exclusively to the earnings *trend, i.e.,* to the *changes* in earnings expected in the future? The answer was, first, that the records of the past were proving an undependable guide to investment; and secondly, that the rewards offered by the future had become irresistibly alluring.
>
> The new-era concepts had their root first of all in the obsolescence of the old-established standards. During the last generation the tempo of economic change has been speeded up to such a degree that the fact of being *long established* has ceased to be, as once it was, a warranty of *stability.* Corporations enjoying decade-long prosperity have been precipitated into insolvency within a few years. Other enterprises, which had been small or unsuccessful or in doubtful repute, have just as quickly acquired dominant size, impressive earnings, and the highest rating….
>
> …Past earnings and dividends could no longer be considered, in themselves, an index of future earnings and dividends. Furthermore, these future earnings showed no tendency whatever to be controlled by the amount of the actual investment in the business—the asset values—but instead depended entirely upon a favorable industrial position and upon capable or fortunate managerial policies….
>
> …less and less attention came to be paid either by financial writers or by the general public to the formerly important question of "net worth," or "book value," and it may be said that by 1929 book value had practically disappeared as an element in determining the attractiveness of a security issue. It is a significant confirmation of this point that "watered stock," once so burning an issue, is now a forgotten phrase….
>
> Thus the prewar approach to investment, based upon past records and tangible facts, became outworn and was discarded. Could anything be put in its place? A new conception was given central importance—that of *trend of earnings.* The past was important only in so far as it showed the direction in which the future could be expected to move. A continuous increase in

* Bejamin Graham and David Dodd, *Security Analysis*, New York, McGraw-Hill, 1934 [1997], 725 pp., $50.00 (hardcover).

profits proved that the company was on the upgrade and promised still better results in the future than had been accomplished to date. Conversely, if the earnings had declined, or even remained stationary during a prosperous period, the future must be thought unpromising and the issue was certainly to be avoided….

Along with this idea as to what constituted the basis for common-stock selection, there emerged a companion theory that common stocks represented the most profitable and therefore the most desirable media for long-term investment. This gospel was based upon a certain amount of research, showing that diversified lists of common stocks had regularly increased in value over stated intervals of time for many years past. The figures indicated that such diversified common-stock holdings yielded both a higher income return and a greater principal profit than purchases of standard bonds.

The combination of these two ideas supplied the "investment theory" upon which the 1927-1929 stock market proceeded…. [T]he theory ran as follows:

1. "The value of a common stock depends on what it can earn in the future."
2. "Good common stocks will prove sound and profitable investments."
3. "Good common stocks are those which have shown a rising trend of earnings."

These statements sound innocent and plausible. Yet they concealed two theoretical weaknesses which could and did result in untold mischief. The first of these defects was that they abolished the fundamental distinctions between investment and speculation. The second was that they ignored the *price* of a stock in determining whether it was a desirable purchase….

A moment's thought will show that "new-era investment," as practiced by the representative investment trusts, was almost identical with speculation as popularly defined in preboom days. Such "investment" meant…stressing the changes of the future instead of the facts of the established past. It would not be inaccurate to state that new-era investment was simply old-style speculation confined to common stocks with a satisfactory trend of earnings. The impressive new concept underlying the greatest stock-market boom in history appears to be no more than a thinly disguised version of the old cynical epigram: "Investment is successful speculation…."

The notion that the desirability of a common stock was entirely independent of its price seems incredibly absurd. Yet the new-era theory led directly to this thesis. If a public-utility stock was selling at 35 times its *maximum* recorded earnings, instead of 10 times its *average* earnings, which was the preboom standard, the conclusion to be drawn was not that the stock was now too high but merely that the standard of value had been raised. Instead of judging the market price by established standards of value, the new era based its standards of value upon the market price. Hence all upper limits disappeared, not only upon the price at which a stock *could* sell, but even upon the price at which it would *deserve* to sell…. [i.e., the PRP!—ed.]

Irrationality could go no further; yet it is important to note that mass speculation can flourish only in an atmosphere of illogic and unreality. The self-deception of the mass speculator must, however, have its elements of justification…. In the new-era bull market, the "rational" basis was the record of long-term improvement shown by diversified common-stock holdings….

There was, however, a radical fallacy involved in the new-era application of this historical fact. This should be apparent from even a superficial examination of the data contained in the small and rather sketchy volume from which the new-era theory may be said to have sprung. The book is entitled *Common Stocks as Long-Term Investments,* by Edgar Lawrence Smith, published in 1924. Common stocks were shown to have a tendency to increase in value with the years, for the simple reason that they earned more than they paid out in dividends, and thus the reinvested earnings added to their worth. In a representative case, the company would earn an average of 9%, pay 6 % in dividends, and add 3 % to surplus. With good management and reasonable luck the fair value of the stock would increase with its book value, at the annual rate of 3% *compounded.* This was, of course, a theoretical rather than a standard pattern; but the numerous instances of results poorer than "normal" might be offset by examples of more rapid growth.

The attractiveness of common stocks for the long pull thus lay essentially in the fact that they earned more than the bond-interest rate upon their cost. This would be true, typically, of a stock earning $10 and selling at $100. But as soon as the pace was advanced to a much higher price in relation to earnings, this advantage disappeared, *and with it disappeared the entire theoretical basis for investment purchases of common stocks.* When investors paid $200 per share for a stock earning $10, they were buying an earning power no greater than the bond-interest rate, without the extra protection afforded by a prior claim. Hence in using the past performances of common stocks as the reason for paying prices 20 to 40 times their earnings, the new-era exponents were starting with a sound premise and twisting it into a woefully unsound conclusion….

…As we have seen, Edgar Lawrence Smith plausibly explained the growth of common-stock values as arising from the building up of asset values through the reinvestment of surplus earnings. Paradoxically enough, the new-era theory which exploited this finding refused to accord the slightest importance to the asset values behind the stocks it favored. Furthermore, the validity of Mr. Smith's conclusions rested necessarily upon the assumption that common stocks could be counted on to behave in the future about as they had in the past. Yet the new-era theory threw out of account the past earnings of corporations except in so far as they were regarded as pointing to a *trend* for the future….

There are several reasons why we cannot be sure that a trend of profits shown in the past will continue in the future. In the broad economic sense, there is the law of diminishing returns and of increasing competition which must finally flatten out any sharply upward curve of growth. There is also the flow and ebb of the business cycle, from which the particular danger arises that the earnings curve will look most impressive on the very eve of a serious setback.

Books such as *Dow 36,000* do seem mainly to make their appearance at or near market tops. Those interested in useful security analysis would be better advised to pick up a copy of the 1934 Graham and Dodd volume. ❑

BUSINESS-CYCLE CONDITIONS

The cyclical statuses of our leading indicators are largely unchanged from last month and the business outlook remains strongly positive.

Three of our twelve leading indicators reached new highs this month. They are *M2 money supply*, *new orders for consumer goods*, and the *ratio of manufacturing and trade sales to inventories*. (M2 and all other dollar-denominated series are reported in constant dollars.) All three series remain appraised as clearly expanding.

Although not at new highs, the *3-month change in sensitive materials prices*, the *index of common stock prices*, and *initial claims for state unemployment insurance* (inverted) are also appraised as clearly expanding. Jobless claims jumped 24 percent to 355,000—owing largely to the lingering effects of Hurricane Floyd. Following on the heels of a 3.8 percent drop last month, stock prices fell another 1.6 percent this month. The successive declines do not yet suggest that the series is declining.

Contracts and orders for plant and equipment climbed 4.3 percent, reversing the downward trend of the series' moving average. *Vendor performance*—the percent of purchasing managers reporting slower delivery time from their suppliers—rose from 51.1 to 55.9 percent. Like contracts and orders, the change in the base data was large enough to reverse the series' trend. Neither development, however, was sufficient to warrant a change in cyclical status—both series are probably expanding.

Four of our leaders have no apparent cyclical trends. *M1 money supply*—the

narrowest measure of money—increased for the first time since March. *New housing permits* authorized in September dropped 7 percent to 1,501,000. The bulk of the decline was attributable to a 19 percent drop in permits for buildings with five or more units. The *average workweek in manufacturing* held steady at 41.8 hours. Despite a dip in this month's base data for the *3-month change in consumer debt*, the series' 4-month moving average strengthened, reflecting a pick-up in consumer borrowing during the summer.

Overall, 100 percent (eight out of eight) of the primary leading indicators with apparent cyclical trends are expanding. Were the four indeterminate series contracting, the percent of leaders expanding—which ignores such series entirely—would still exceed 50—the mark above which expansion is more probable than recession. The cyclical score, AIER's purely mathematical assessment of the twelve leaders, weakened 2 points to 80, but remains well above the threshold of 50 (below which signals imminent contraction).

Three of our six primary roughly coincident indicators reached new cyclical highs, namely *personal income in manufacturing*, *manufacturing and trade sales*, and *gross domestic product* (GDP). All three series remain appraised as clearly expanding. Personal income in manufacturing rose, boosting average hourly and weekly earnings in the sector to $14.12 and $587.39, respectively. The final estimate of second quarter GDP growth—based on more complete source data than earlier estimates—was revised down 0.2 to 1.6 percent.

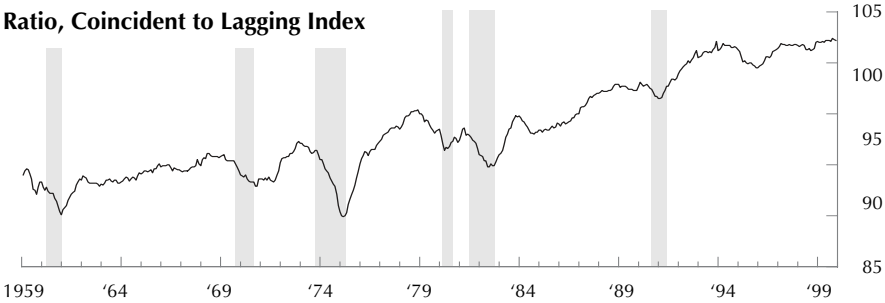
Two series—*nonagricultural employment* and the *index of industrial production*—are one month off their cyclical highs but remain appraised as clearly expanding. Nonfarm employment fell by 8,000 to 128,911,000. Job losses in the manufacturing, retail, and government sectors were largely offset by gains in the construction and service industries. *Civilian employment as a percentage of the working-age population* remained at 64.1 for the third straight month. The series is indeterminate. Overall, 100 percent (five out of five) of the primary roughly coincident indicators with apparent cyclical trends are expanding.

Four of our six primary leading indicators reached new cyclical highs and are appraised as clearly expanding, including the *average duration of employment* (inverted), *manufacturing and trade inventories*, *commercial and industrial loans*, and the *ratio of consumer debt to personal income*. The average duration of unemployment fell to 12.8 weeks, its lowest level since May 1991. Unemployment totaled 5.8 million, and the unemployment rate held at 4.2 percent.

The *composite of short-term interest rates* is now up roughly 50 basis points since January and stands at 5.33 percent. The series is probably expanding. The *percent change from a year earlier in manufacturing labor cost per unit of output*—is slowly inching its way into positive territory in absolute terms, although no identifiable trend is yet present.

Overall, 100 percent (five out of five) of the primary lagging indicators with apparent cyclical trends are expanding. When the lagging indicators are strengthening, expansion-thwarting bottlenecks may be developing. But, in spite of continuing record highs in manufacturing and trade inventories, sales have maintained pace, keeping the sector in balance. Moreover, the ratio of coinciders to laggers has not weakened, as would be expected if bottlenecks were forming. In sum, the outlook for the economy is favorable. ❑

Ratio, Coincident to Lagging Index



Statistical Indicators of Business-Cycle Changes

Change in Base Data Jun.	Jul.	Aug.	Sep.	*Primary Leading Indicators*	*Cyclical Status* Aug.	Sep.	Oct.
-	-	+		M1 money supply	+?	?	?
+	+	+		M2 money supply	+	+	+
+	+	-		Change in sensitive materials prices	+	+	+
+	+	+		New orders for consumer goods	+	+	+
-	+	+		Contracts and orders for plant and equipment	+?	+?	+?
+	nc	-	-	Index of new housing permits	?	?	?
+	-			Ratio of manufacturing and trade sales to inventories	+	+	+
+	+	-	+	Vendor performance	+?	+?	+?
-	+	-	-	Index of common stock prices (constant purchasing power)	+	+	+
nc	+	-	nc	Average workweek in manufacturing	?	?	?
+	+	+	-	Initial claims for unemployment insurance (inverted)	+	+	+
-	+	-		Change in consumer debt	?	?	?
				Percentage expanding cyclically	100	100	100
				Primary Roughly Coincident Indicators			
+	+	+	-	Nonagricultural employment	+	+	+
+	+	+	-	Index of industrial production	+	+	+
+	+	-		Personal income in manufacturing	+	+	+
+	+			Manufacturing and trade sales	+	+	+
+	-	-	nc	Civilian employment to population ratio	?	?	?
+				Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	100	100	100
				Primary Lagging Indicators			
-	+	+	+	Average duration of unemployment (inverted)	+	+	+
+	+			Manufacturing and trade inventories	+	+	+
+	+	+		Commercial and industrial loans	+	+	+
-	+	+		Ratio of consumer debt to personal income	+	+	+
-	+	nc		Change in labor cost per unit of output, manufacturing	?	?	?
+	+	+	+	Composite of short-term interest rates	?	+?	+?
nc No change.		r Revised.		*Percentage expanding cyclically*	100	100	100

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

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