MuhlenkampMethods
For the Intelligent Investor
Answers to questions you may not even know you have.

# The "Fad," Recession, and Getting Back to "Normal"

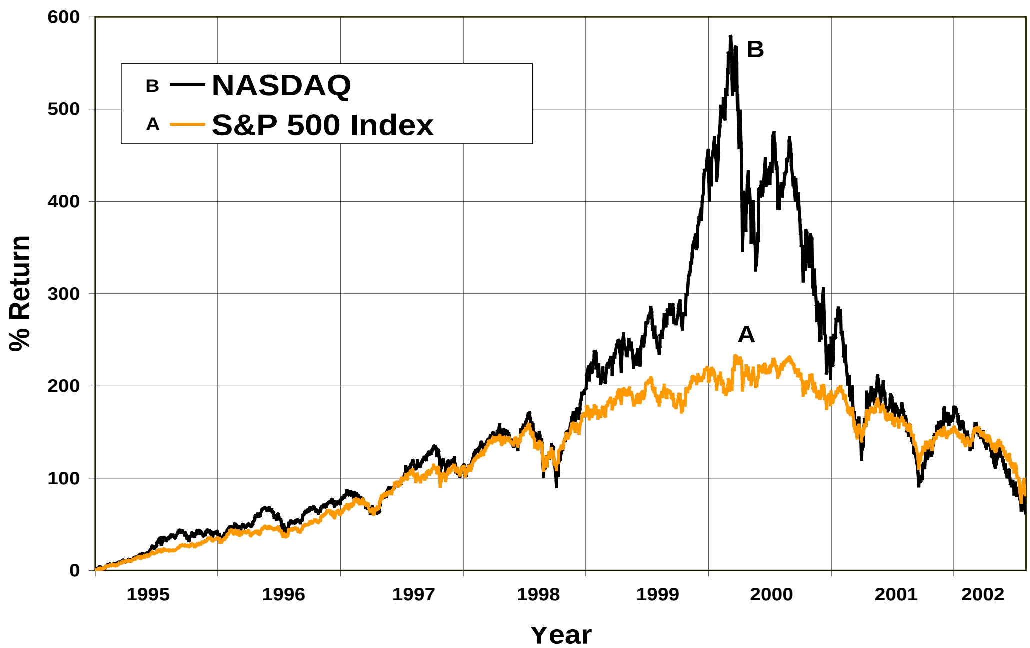
*Adapted from a presentation delivered at the December 2002 Muhlenkamp & Company Seminar. The investing community was still trying to come to grips with the dramatic fluctuations in some stock prices (commonly referred to as the Tech Stock Bubble). Ron presents an argument of why those prices rose and fell, and what to make of it.*

Starting late in 1998, the American public discovered the game of the stock market. A number of people bought computers, got onto the Internet, and discovered day trading. Being computer types, they fell in love with tech stocks, as well as online brokers, and tech stock prices climbed. They climbed so dramatically that more people joined the rush. And Wall Street, a superb marketing organization, helped and encouraged them in believing and buying more of what they wanted. For 18 months, the game of the stock market became a favorite American pastime. But it was a fad. The prices were inflated by the craze, and for the next 18 months, the tech stock prices gave it all back. (The rise and fall of the tech stocks are

Muhlenkamp & Company, Inc.
Intelligent Investment Management
5000 Stonewood Drive, Suite 300 • Wexford, PA 15090 • (877) 935-5520 • www.muhlenkamp.com

shown by the NASDAQ line (Line B) on Figure 8.17. The rest of the market is depicted on the chart by the S&P 500 Index.)

**Figure 8.17 NASDAQ versus S&P 500, 1995–2002***




**Data through August 6, 2002.*

Think about that. In a three-year period, a fad involving millions of people and billions of dollars went full circle. What made the whole thing even more dramatic was that many of the investors were new to investing. It's human nature that when enter an area s unfamiliar area, like finance, we often assume that the time we enter is a normal time. It's like the traveler who visits another country and assumes that the weather they experience is normal for that region in that season. But when they ask the locals, they find out it is a record-breaking event. That's how it was for those who invested in tech stocks, and no one was listening to the locals who said it was a fluke.

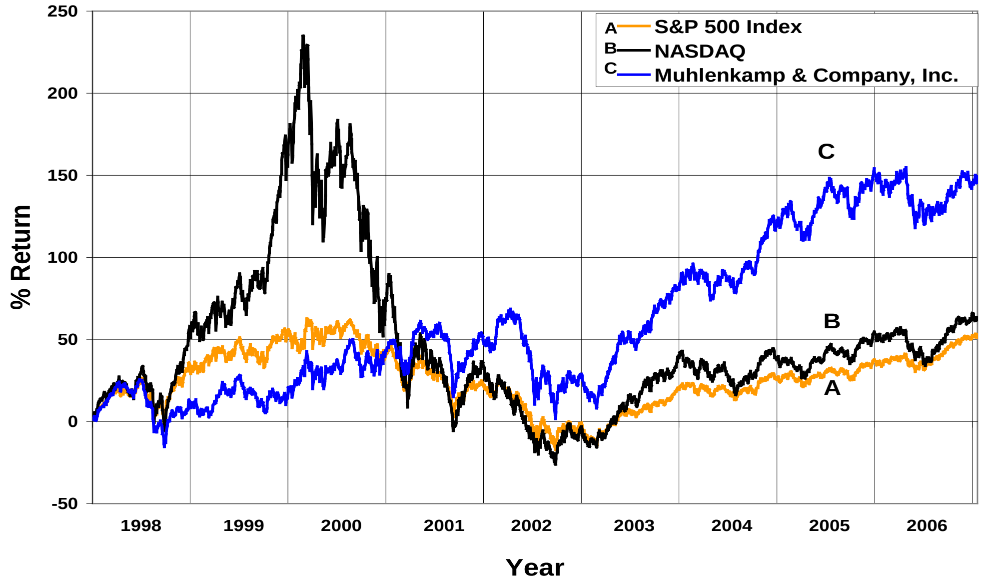
Thus, many of the new investors believed that rapidly rising prices were "normal" and therefore were not prepared for the decline that followed. They were left groping for answers. "What happened?

Why did my stocks' prices fall?" And the locals would answer, "They had to. Those prices were inflated." So then they ask hopefully, "When are the tech stocks coming back?" The local might reply dryly, "Not until you stop asking." And being new to the region, and still somewhat in shock, the newcomer laments, "But I did so well in '99." The local looks them in the eye and says, "Well, '99 is over. The best thing you can do is pretend that those prices never occurred because they weren't real to begin with."

So what were the more seasoned investors doing during this time? Well, many were playing the game as well. A Wall Street analyst's job is to make money for the investment firm he works for. That means bringing in clients. If an analyst or stock broker chose not to invest in tech stocks in '98 and '99, he lost clients. Besides, it was very hard not to get caught up in the fad. Tech stocks were climbing impressively, and many thought the tech rush was real and sustainable. The technology was real, though the prices paid for the companies were not. The Internet was viewed as the "new railroads" (railroads having been a great economy-changing industry in the 1800s). Few commentators bothered to mention that the average railroad in the United States has been bankrupt four times. People wanted to believe that the tech fad was real and sustainable. So why wouldn't you invest in tech stocks?

Have you ever heard the expression, "If it seems too good to be true, it probably is"? Well, it's true in the stock market, and in the stock market there is a corollary, "If everyone thinks it's a good buy, it no longer is." By the time the general populace is aware of a good stock, they've usually already driven the price up enough that it is no longer a good buy. No matter how good the company, if the price is too high, it is too high. So in the stock market, it helps to be an independent thinker. (I almost wrote "to be a little contrary" but you have to know when to be contrary.) That's where investing fundamentals come in. But in the 1998–2002 market, even those investors who chose to stick to fundamentals and to stay out of tech stocks didn't go unscathed.

**Figure 8.18 NASDAQ vs. S&P 500 versus Muhlenkamp & Company, 1995–2006***




**Data through January 31, 2007.*

I discovered in high school that I'm no good at fads, so in 1998 we declined to play the tech stock game. Instead, we kept to the basics and invested long-term, looking for value companies at good prices. In 1999 when tech stocks were soaring, we looked pretty dumb. In 2000 and 2001, we looked a little smarter. Then in June and July 2002, a lot of people, fed up with the stock market, wanted out regardless of price. This brought the whole market down. We got caught in that. We kept about 10% cash early in the year knowing it could happen, but it wasn't enough to escape unscathed.

Now it's the end of 2002, (we've updated Figure 8.18 through 2006), and the fad is over except for the tax-loss selling. People who look at tech stocks today tend to remember either the price that they paid or the high that the price hit, which means that every time they look at tech stocks, it's going to be painful. To relieve that pain, over time they will sell those stocks. Typically, when the stock market sees this kind of drop in prices, you have to go through two tax seasons before the tax-loss selling is complete. In 2001, nobody had any gains, so there wasn't much tax-loss selling. Therefore, it will likely be a couple of more years before the tax-loss selling is complete.

The year 2002 has been the first time since World War II that, in an economy coming out of a recession, stocks did not do well. We believe it's because of a psychological overshoot. In the short term, stock prices are governed by human psychology. For periods up to six months, it's always psychology. For six months to three years, sometimes it's psychology. Beyond three years, the volatility of hope, fear, and hype average out, and stock prices are governed by what I call business economics. In 2002, fear overrode or delayed what happens in the normal business cycle. There was fear and uncertainty following the fall of tech stocks. There was fear and uncertainty following the September 11 attacks. There is fear of al-Qaeda, there is uncertainty about the food supply because of the drought. We even had snipers in Washington, D.C. Someone said to me that it was as if God were a centipede. Usually, in a bad time, two or three shoes drop. But this year the shoes just keep dropping. And so, the short-term market has been dampened by uncertainty. But the long-term is still governed by business economics. So let's look at what happens, long-term, when there is a recession.

## Understanding the Recession

This has been our tenth recession since World War II. In the 1960s and the 1970s we got a recession every three to five years, to the extent that I concluded that recession is a normal part of the business cycle. That remains true. But we're now in only the second recession in 20 years, which means we have a whole generation of people who don't know how to act, or how markets act, in a recession. In the 1960s and 1970s, my observation was that until people had been through four or five recessions, people viewed them as catastrophic. If you talk to people in their seventies or eighties, they say, "Oh yeah, another recession." If you are getting something every four or five years, it's a normal part of life. If you only get it every 10 years or so, it's a rather unusual occurrence. We have a whole younger generation that doesn't quite know how a normal, cyclical recession works.

Recessions, by themselves, are inherently self-correcting. In a recession, the average person works a little harder, spends a little less, saves a little more, in case he loses his job. But in a recession only 2%–3% of the people actually lose their job; 95% don't. After six or nine months, this 95% concludes that they're not going to lose their job. Then they gravitate back toward the kind of spending they were doing before.

That's a normal recession. But every now and then, we mess things up and we turn a recession into something more difficult. In the 1930s, we turned it into a depression. In the 1970s, we turned it into inflation. Each was a major "climate change," when the normal processes were suspended, or even reversed. Let's see why.

First, let's look at the Great Depression. In the late 1920s–early 1930s we did three things:

- In order to protect our gold supply, we raised interest rates.
- In order to balance the federal budget, we raised taxes.
- In order to help our manufacturers, we raised tariffs.

Each of those actions, by itself, sounds reasonable. But think about what you do to the consumer when you raise interest rates, raise taxes, and raise tariffs. You kill the consumer! And we turned a recession into a depression. This time around, we lowered interest rates and we lowered taxes. At the end of 2002, we started playing some dumb games with tariffs on things like steel and farm products, but it's not enough to offset the lower taxes and interest rates. We've concluded that we are not facing depression coming out of this recession.

In the late 1960s, partly in order to prevent recession, we printed money and created inflation. In the late 1960s we could do that, because we were lenders to the rest of the world. The current slowdown in the economy was an intentional attempt to avoid inflation. Alan Greenspan all but said, three years ago, that he'd take a recession rather than inflate the money supply. We slowed this economy down on purpose to avoid inflation that hadn't even shown up yet! Today, we're overly sensitive to inflation the same way we were undersensitive to inflation in the 1970s. The fact that we're overly sensitive means that we won't inflate.

The third thing that can create a long-term climate change following a recession is war. In our newsletter of July 2001, we said we thought war was unlikely. The terrorist attacks of September 11 proved us wrong, but there are reasons to think this war will not create a long-term climate change.

- First, the war we're now in is not a total economic commitment like World War II was.
- Second, from the moment of the attacks, the American people were helping each other. It started in New York, but within a few minutes it happened throughout the country. If the American public, after September 11, was hiding in their homes saying, "I'm not coming out until . . . ," then, we would worry about the long-term picture. But, in fact, from the first moment Americans were supportive of their neighbors throughout the country.
- The third thing we saw, within a few weeks, was General Motors saying, "We'll sell you cars at a 0% interest rate," and people went out and bought cars.

We've concluded that this is a normal, cyclical recession—and not a major change in the long-term climate. The long-term climate is positive, not negative. The coincident indicators like factory utilization and consumer spending bottomed in December 2001. Not all things have bottomed yet, but the things that haven't are lagging indicators—things like unemployment and capital spending. Corporations don't usually go out and spend new money on capital equipment or add employees until they see money coming in from their retail sales or sales to their customers. So unemployment and capital spending lag the economy, awaiting corporate decision. And today, they're lagging, as they should. They lagged on the upside, and they lag on the downside. Frankly, we think the bottom of stocks was a year and a half ago, which it was—if you were in anything but tech stocks. So what we've done for the past four years is to play the normal, cyclical rotation that follows a recession instead of playing the hype stocks.

## Getting Back to "Normal"

We are getting back to normal, but it's a normal we haven't seen since 1965. Inflation is stable, averaging 2%–3% for the last 10 years. Long-term Treasury bonds are valued at 4%–5%, which is fair. And the average P/E for equities is 17, also fair. (In 1965, inflation was stable for 14 years, averaging 1.5%; bonds were stable at 4.5%; and the average P/E was 17, stable for seven years). The other thing that is back to normal is that nearly every industry has ample capacity. With ample capacity, a company must outperform its competitors to do well. For Wal-Mart to do well, they will have to do it at the expense of JC Penney and Kmart. For General Motors to do well, it will do well at the expense of Ford and Chrysler.

The first question I get from anybody in the media is, "Which way is the market going?" And I ask, "Which market?" We've been in a split market for four years. You cannot talk about "the market." The market that they probably want to monitor is the NASDAQ, or the high-tech stuff. We've ignored that. It was hype. The second question they like to ask is, "What sectors do you like?" But that game is over. When changes in inflation were driving all of this, in the 1970s, it didn't matter how well individual companies did. Inflation running up, driving P/Es down, overwhelmed that. In the 1980s, with inflation coming down, driving P/Es up, all stocks went up. That game is now over. And because we have ample capacity, it's how individual companies perform that matters: how well they do versus the competition.

In 1965 nobody asked, "Which way is the market going?" or "What sectors do you like?" They asked, "What companies do you like? Which companies are beating their competition?" We are back to that. The fact that, right now, the media is reading everything negatively gives us a chance to see more data and to buy things with more conviction than we otherwise would. You make money when perception differs from reality. Today, the reality is good; the perception is bad. That's a stock-picker's dream.

Some people say, "But, prices are down." Well, yes, that's why I'm excited! Everything else in your life you want to buy when it's cheap, when it goes on sale. The only thing that people want to buy after it goes up is stocks! But that's because when it comes to stocks, all most people know is price. They are extrapolating price trends rather than looking at value. When it comes to cars or houses or clothing or most things in life, you have a pretty good idea of value. So you get excited when prices get well below value. But with stocks, many people don't know the value of a company. When I started in this business in the early 1970s, I started asking analysts what a company was worth and nobody could tell me. They would say, "Well, the P/E used to be 15, but now it's 12." I said, "So, what's the company worth?" and they couldn't tell me. To invest in a company based only on price trends, and not know the value of the company is a risky game. But if you can determine what companies are worth and understand the economic climate, you can make rational choices. You are in the business of investment.

## Editor's Note

*It is interesting that not only has the economic climate come full circle since 1965, but this essay has in some ways come full circle from Ron's 1979 essay, "Why the Market Went Down." In both essays, Ron is addressing the fears of investors (or money managers) who felt the fall of the market was unpredictable and irrational. In both cases, he shows that they needn't fear. Though the market can be volatile in the short term, in the long term it is rational. So for the long-term investor, the intelligent approach is to understand the past, assess the present, and be prepared for the future.*