Rip Van Winkle

September was another difficult month for stocks, and I want you to know that I see no cause for concern.

Even though pessimism currently abounds, the time for greatest concern has passed. The time to be concerned was in the late 90's. Optimism was the order of the day. The book Dow 36,000 was hitting the shelves, stocks were guaranteed to be the best investment in the long run, and the stock market was no longer considered risky. We stuck to our knitting and ignored the conventional wisdom. Consequently, Alpine client capital was protected from the bubble and its demise.

Today is different. The clear danger of ridiculously high prices is gone. Stock market risk is more normal. The market is still high, but it is within normal bounds. The recession lingers, but recessions are to be expected, and they are figured into our stock valuations. The wild card is terrorism. Yet, each generation seems to have its own wild card, and the fear of it is almost always worse than the ensuing reality. (If you are interested in more detail about the possible economic consequences of terrorism, please contact me to receive information from one of my previous letters).

So what are some of the more normal stock market risks that we are facing? The two primary risks that we seek to avoid, always, are low-quality companies and high-priced stocks. Avoiding these risks is easier said than done, although it is very doable.

General stock price volatility is another risk of investing in stocks, even when you buy quality companies at reasonable prices. Yet, we do not seek to avoid this risk, because it cannot be avoided. Stock returns come at a price, and that price is volatility. The only way to avoid stock price volatility is to not invest in stocks. Funds that will be needed in the near-term should be invested in cash or bonds.

Interestingly, one of the greatest risks of investing in stocks has nothing to do with companies, prices, or volatility. As the comic strip character Pogo has noted: "We have met the enemy and he is us." Our own human nature can be our worst enemy, causing us to sell when we should be buying and to buy when we should be selling. After all, it is human nature to feel bad when stock prices are down and to feel good when they are up. Yet, what really matters is that your money is there when you need it in the amount you expect. Anything in between is purely academic. The problem is that the in-between part can get pretty hairy. The only way to combat our emotions during such times is to examine and reexamine the facts.

Here are a few facts regarding the current Alpine portfolio. First, it is comprised of quality companies. This means reliable earnings streams, low levels of debt, and good returns-on-capital. Second, the average Alpine company is selling at a price 13 times higher than its current earnings. The historical

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average for the stock market in general is 15 times earnings. Moreover, we remain in an earnings trough from recession. Alpine stocks are selling for an average of 11 times what I expect their earnings to be under more normal conditions. Third, the average Alpine company growth rate is higher than the growth rate of the overall economy. Translation: The Alpine portfolio is in great shape. This is in contrast to the overall market, which is selling for a price 21 times higher than its current earnings.

Make no mistake, the Alpine portfolio can always get cheaper. A decline of 30% – from 13 times earnings to 9 times earnings – would not be unprecedented in stock market history. While I do not expect such a decline, as long as earnings remain sound, there would be nothing to worry about. The decline would eventually be offset by a commensurate gain, on top of normal business growth and dividends paid.

And that is why I have always been an advocate of the Rip Van Winkle approach to investing. Under this approach, one initially pays a reasonable price for a quality business. Then, they sleep through the inevitable stock price ups and downs (though they are quite alert as to the operating performance of the business). Finally, they wake up in 5-10 years to find that they have made a considerable sum of money.

Nick Tompras
September 2002

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