

Market Psychology and Economic Facts

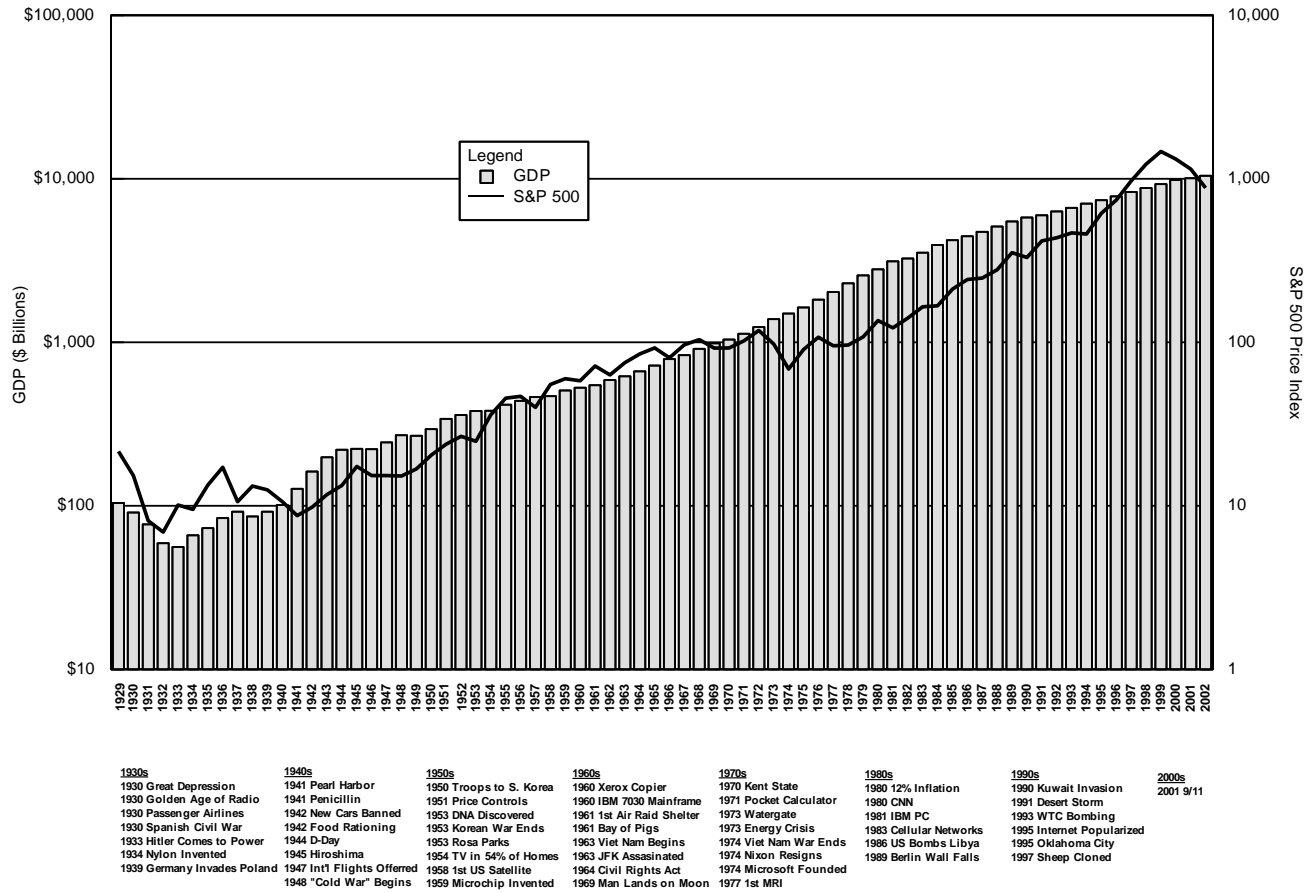
Alfred Hitchcock once said that the best way to strike fear into the heart of his audience was *to not show* a horrible scene. He would simply let the audience's imagination – a more potent force – do the work for him.

Stock investing is similar in this respect. Stock prices reflect our collective views about *what we can't see* – *the future*. When the public believes there is something bad behind the veil of the future, their imagination often takes over and they overreact by selling in a panic or refusing to buy. They do the converse when they think the future is unusually good. This psychological phenomenon has been playing out ever since the first security traded on an organized exchange.

The good news, as it regards the stock market, is that *we do know* more of what's behind the veil than we think. Let us begin with some basic economic logic. The United States has maintained a viable capitalist system for many years. A viable capitalist system contains corporations which produce net income. Ownership in these corporations entitles you to this net income, and this net income establishes the value of what you own. As long as the economy is around, and as long as you own sound income-producing companies, you will own a *valuable* resource on which you can rely on for dividends and long run capital appreciation.

The chart below supports this view.

The Big Picture



It contains three series of data spanning from 1929 to 2002. The first is Gross Domestic Product (GDP), which is a proxy for economic and corporate values. The second is the Standard & Poor's 500 Price Index, which is both a proxy for corporate values, as well as a barometer for the fear and greed of market participants. Lastly, a number of major historical events are included to show how the economy and the stock market respond to them.

A few observations. First, GDP shows a rather steady and even rise (except for the Great Depression). Second, it appears virtually impervious to historical events. Third, stock prices fluctuate in a zigzag fashion compared to GDP, supporting the theory that market participants over-react based on fear and greed. Fourth, the jagged movements in the stock market are typically short-term. Rising prices *usually* offset declining prices within a 2-5 year period. Fifth, we have had two *protracted* periods of poor stock market performance. I would like to spend more time on this point, since it is on the surface most disconcerting. Furthermore, by taking a peak behind the veil of "how bad it could get", we have the opportunity to face our worst fears. (Sneak preview – it's not that bad.)

The first period is during the Great Depression. Stocks did not surpass their 1929 highs until 1951 – a 22 year period! *But what about dividends?* The yield earned on dividends over the period (based on the 1929 close) was 3.5%. Not great, but positive. Furthermore, dividend reinvestment resulted in a total return of 6.4%. This compares to a return of 3.5% for long-term treasury bonds and 0.6% for cash. Similar conclusions may be derived from examining the second period, from the mid-60's to the early 80's. The moral of the story is as follows. First, the *income-oriented investor* may largely ignore stock market declines in the short run (less than 10 years) provided a simple but critical rule is followed: Structure the stock and bond portfolio to provide a satisfactory income *primarily* from dividends and interest, and to a much lesser extent, from bond maturities. Additionally, certain stocks are bound to perform better than the average during difficult times. Timely sales of such issues may provide a third source of funds until general market conditions improve. Second, the *growth-oriented investor* with a long-term time horizon (10-20 years) *will welcome a protracted period of market weakness* because it allows for dividend reinvestment and additional purchases at bargain prices.

Perhaps the most important observation from our examination is that the paltry returns earned during such periods may be greatly improved by avoiding speculative prices in the first place. Alpine clients do not own the stock market – we own a limited group of stocks purchased *at reasonable prices*. At the market top, the average Alpine stock portfolio was selling at a price 11-13 times higher than its earnings versus 30 times for the overall market. The current Alpine portfolio is selling for a price only 12 times higher than its earnings versus 21 times for the market. *Avoiding speculative prices may not protect us from short-term declines, but it bodes well for our long run performance.*

So when stock prices decline, including those in your portfolio, it remains ever important to stay the course. The record shows that (a) stock price declines usually prove transitory, and (b) the rewards of stock investing accrue to those who remain committed to a sound long-term strategy based on economic fundamentals. *Those same fundamentals, in my opinion, suggest an intrinsic value for the average Alpine-selected stock account that is roughly one-fourth higher than is currently being reflected. The only guaranteed way to lose that value is to sell at the wrong time.*

Nick Tompras
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