Bradley, Foster & Sargent, Inc.
Investment Management

Is the Stock Market Showing Signs of Irrational Crowd Behavior?

During the second quarter of 1996, the stock market showed unmistakable signs of froth. Or perhaps a better image is that of a bubble threatening to burst - as in the notorious 18th century South Sea Bubble. During the first half of 1996, Securities Data Co. reported that there were 434 Initial Public Offerings (IPOs) in which the public invested $28.1 billion. This is a torrid pace. The previous record for IPOs was in 1993 when IPOs raised $34 billion for the *entire year.* And most investors in these IPOs over the past six months profited handsomely on the first day or two of purchase. During the second quarter, the stock of most IPOs went straight up. It was like shooting goldfish in the proverbial barrel. Many of the companies going public had no earnings, and some had no revenues. It didn't matter. Crowd psychology dominated, and the crowd, emboldened by the flood of money pouring into equity mutual funds, was in a buying mood.

Another unmistakable sign of excess during the past three months was the trading patterns of some of the emerging growth stocks listed on the NASDAQ (OTC) market. It was not uncommon to find stocks selling at 20 times revenues. As long as the company was involved in the Internet or developed software or had the word "technology" in its name or logo, "momentum" players were seemingly willing to pay up to 100 times revenues. Momentum, which is a major investment strategy these days, is of course another word for the greater-fool-theory. In other words, one should purchase a stock on the assumption that one can always find another fool willing to pay more. This psychology is what has driven the great market manias - the South Sea Bubble, the Mississippi Land Scheme, the Tulip Bulb market in Holland in the 17th century, the Souk Al-Manak in Kuwait in the early 1980's and numerous other less well known market bubbles.

To get some perspective on the current stock market, it would be helpful to get out a copy of the classic work, *The Money Game*, written by "Adam Smith" (George J.W. Goodman) in 1967 - near the peak of the great bull market which went from the early 1950's until the end of 1960's. He correctly foresaw that the stock market was at a major top and described with great wit and perspicacity many of the enduring features of a stock market bubble. *The Money Game* should be required reading those young mutual fund managers who have never seen a real bear market. Can they appreciate that the Value Line Index of 1,700 stocks dropped 70% between the market top in 1968 and the bottom at the end of 1974? Even the Standard & Poor 500 Index lost 43.4% between 1972 and 1974.

Madness of Crowds

One of Adam Smith's chapters in *The Money Game* is entitled "Is the Market Really a Crowd?" In it, he draws from David McKay's famous work, *Extraordinary Popular Delusions and the Madness of Crowds,* written in 1842. Bernard M. Baruch said that McKay's book helped him to make a fortune. Adam Smith also quotes the work of Gustave Le Bon at the end of the 19th century called *Psychologie des Foules,* translated as *The Crowd.* Le Bon says that an individual in a crowd acquires - just from being in crowd - "a sentiment of invincible power which allows him to yield to instincts, which had he been alone, he would perforce have kept under restraint...The sentiment of responsibility, which always controls individuals, disappears entirely." Moreover, a crowd demonstrates, according to Le Bon, a certain contagion which is communicated to members of the crowd as well as the characteristic of suggestibility described above. In other words, once we are in a crowd, we are ripe for contagion, suggestibility and acts of "irresistible impetuosity." (This was written in 1895 long before Mussolini, Hitler and Mao). The question, for us investors then, is: are we currently part of some behavior which might be characterized as "crowd madness" in our investment approach during 1996 or does rationality still prevail?

Any dispassionate observer of emerging growth stocks and IPOs over the past six months would have to agree that there was more than a touch of the "madness of crowds" in those sectors of the stock market. The only way to invest profitably in those markets in 1996 was, in the immortal words of Adam Smith, to "get yourself a kid with no memory and no scars."

A good example of the general craziness in this sector is the company Yahoo, which came public in April this year. Yahoo, which is headquartered in Sunnyvale, California, provides a "navigational service" on the Internet for subscribers to the World Wide Web. When it went public in April, the company had achieved revenues for the first quarter of 1996 of $2 million and had produced a loss for the quarter. On the day it went public, investors gave it a market capitalization at its peak of $1.1 billion. Stock was issued at $13 a share, and the first trade was at $24. During the day, the price of the stock reached $43 a share. Currently it is trading at $17 which, with 25.7 million shares outstanding, gives it a market value of $436 million - or 43 times annualized revenues.

Stock Market Valuation

Generalizations about the stock market are often misleading. While this craziness prevailed in various speculative sectors, the large capitalization stocks which make up the Dow Jones and the Standard & Poor 500 Index traded on a much more rational basis. Even at the Dow Jones peak of 5,796 on May 23, 1996 the P/E ratio on estimated 1996 earnings was 15.7, which, while not inexpensive, is reasonable, considering an inflation rate of less than 3%. The Standard & Poor 500 Index hit its all time high of 681 on the same day as the Dow Jones. At this level, the S&P 500 was trading at approximately 17 times estimated 1996 earnings - once again, not cheap but reasonable, taking into account inflation of 2.9% over the past twelve months. The traditional measuring stick for the market, the Rule of 20, mentioned before on these pages, calls for the market to trade at 17 times earnings with inflation forecast at 3% or less. According to a recent Lehman Brothers report, another key valuation ratio - price to cash flow - shows that the stock market is actually valued at less than the average price/cash flow during a similar low inflation period between 1958 and 1972. On the other hand, it should be noted that there are several other key measures of valuation - such as price to dividends and price to GDP which show significant overvaluation.

Another positive aspect of this stock market has been its inherent self correcting mechanism. As speculation in sectors such as small capitalization stocks have become excessive, it has tended to trigger a rush for the exits in these areas, causing drops in some shares of 65% or more. While painful for speculators, this has had a beneficial effect on the overall stock market.

Whatever the level of valuation, when poor second quarter results were released by Motorola, and Hewlett Packard pre-announced that orders in several of its key divisions would be less than robust, the news from these two market bellwethers triggered the long awaited forecast correction. Several weeks of huge trading volume and significant volatility (including two days with the Dow Jones off 170 points) brought the Standard & Poor 500 Index down 10% before it rebounded to close on Friday, July 19 at 638. At this level, it is up approximately 4% for the year (including dividends). On the other hand, rising interest rates, caused by fears of stronger than forecast economic activity and the threat of higher inflation, have led to lower bond prices, causing 30 year U.S. Treasuries to post a total return of -7.2% for the first 6 months of 1996.

Investment Outlook

This divergence in investment returns cannot last too much longer. If interest rates continue to rise, stock prices will not long be able to buck the tide, and we would expect the stock market to drop further, possibly breaking the 5,000 level. On the other hand, if interest rates were to stabilize or decrease causing the bond prices to rally, the stock market would probably retest its May high. For the stock market to make new highs, we would need to see higher corporate earnings than forecast or a significant drop in interest rates. We do not see either happening soon. In fact, we believe there is at least a 50% chance of the Federal Reserve increasing interest rates at their August meeting. The economic scenario of a rather robust second half of 1996 followed by a weak 1997 is rather plausible to us.

What does all this mean in terms of investment strategy? First, it means that we continue to believe that Bradley, Foster & Sargent's investment philosophy of investing in high quality growth companies at reasonable prices will serve our clients well. It also means that we will continue to avoid the highly speculative, emerging growth sectors of the stock market, where "crowd behavior" has reigned over the past 12 months. It also means a continuing emphasis on prudent asset allocation, careful selection of fundamentally attractive industries and companies, and good diversification. Finally, it means holding on to excellent companies, which were bought at good prices, rather than trying to market time when to sell them and then buy them back at lower prices. Ultimately, the stock market is a market of individual stocks, many of which are still at attractive prices.

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