

MEMO

From Robert Zevin

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The spectacular stock market returns of 1995 through 1998 seem to have ended. Most large, multinational companies with reputations for consistent, high growth of their businesses have been disappointing investments for the past year and one half. Walt Disney, Phillip Morris, Coca-Cola, Gillette, Avon, Kellogg, Pfizer, Merrill Lynch and many similar household-name companies are selling well below their peak prices of the spring of 1998 and 1999. In most cases they are unchanged from the beginning of 1998.

I have been avoiding these types of stocks for all of the past year and one-half, because I thought they were too expensive. Are they still too expensive? If a company's earnings grow at 10% a year and the price of its stock doesn't change for 21 months, that would make it 15% less expensive relative to earnings. However, earnings growth has faltered or reversed for many of these companies because of the global financial turmoil of 1997 and 1998; because of the very high exchange value of the dollar and for a variety of more particular reasons. Moreover, at their peak prices they needed to come down approximately 30% relative to earnings in order to be attractive investments. And interest rates have risen quite substantially, which implies that these companies should sell at still lower prices to remain attractive investments. So, as a rule, the household-name growth stocks are still much too high.

So far in 1999, through September 30th, the S&P 500 Stock Index was modestly ahead of these consumer growth stocks with a total return of 5.4%. This is still rather paltry compared to gains over 20% in each of the previous four years. The S&P was only able to do this well because of leading technology companies like Microsoft and Intel and because of the rebound in commodity prices and in the stocks of oil and paper companies among other commodity producers. However, in recent weeks the commodity company stocks have also faltered along with an expanding number of technology companies.

Meanwhile, continued economic growth in the U.S. and rebounding growth in most of the world continues to provide a favorable atmosphere for smaller American companies and for many overseas companies. Most of these companies are not selling at significantly inflated prices. And many of them have growth prospects as good or better than more famous U.S. growth stocks.

The catch in all this, as I mentioned in my memo three months ago, is that economic strength here and in the world is being stimulated by our strong stock market. As the market weakens it may impact the real economy or investors might fear such an impact leading to further market weakness. This interaction between the stock market and the economy is the most plausible way that a market decline could turn into a crash.

The Federal Reserve has been fearfully alert to such a possibility, providing more money and lower interest rates at each hint of vertigo. More money and lower interest rates are the fuel for transcendental stock markets. Hence the catch. Should Greenspan cause a market dive now or should he avoid one at the cost of making a future dive even steeper?

The most likely way out of all this would be an orderly decline in equity prices followed by a return to more modest annual increases, in the same range as increases in earnings, dividends and economic activity. So far events are consistent with this possibility. Consumer growth stocks have stood still for 21 months. Internet stocks have lost half their value since January (after increasing ten fold in the previous three months). Interest rates have been gradually increasing to reflect the age of this recovery and the reality of slightly increased inflation. More likely than not, prices of most stocks will fall another 10% or so. And after that we may live in a world where stocks produce average annual returns of about 8% rather than the 18% we have seen since 1982.

I continue to invest in smaller companies and in foreign companies that are reasonably priced. I continue to favor companies that are likely to grow even in a recession. These appear particularly in the telecommunications, technology and health care industries. But, above all, this remains a time for protecting asset values and resisting the temptations of excessive speculation.