HILLSDALE

A leader in Alternative Investment Strategies

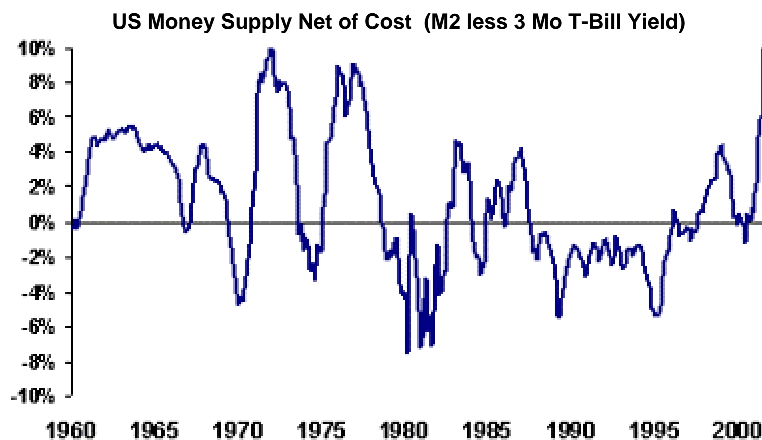
Hillsdale Investment Outlook for July 2002

The Big Picture

As all of our performance related marketing materials dutifully note, “past performance is not indicative of future returns”. If ever the market needed to pay heed to this comment, now is the time. For those investors who like to stay firmly focused on the rear view mirror, this is about as ugly as it gets. During the month of July, and despite and strong late month surge, the S&P 500 price index still fell by 8%. It is now down almost 40% from its peak month end close in August 2000 and is within a hair length of surpassing the September 1974 drawdown, set during the terrible 73/74 bear market, when the index dropped by 42%. For long-term investors, the rolling annualized five year return stands at a mere 0.2%, a level not seen since 1974 and 1978. There are only two other time periods when the market has suffered worse drawdowns and lower five year returns, those occurring in 1941 and during the depression of the early 1930s. The current market has now earned the dubious distinction of being tied for third worst over the last century.

How Did We Get Here?

Throughout time and going back for the last several hundred years, most financial manias and bubbles have been jump started by a large dose of excess liquidity. This one was no different. Alan Greenspan, during his July testimony before Congress, blamed market participants for becoming overcome by ‘infectious greed’. Notably, he forgot to mention that prior to the greed, market participants were swamped by infectious liquidity provided largely by the Fed itself, as it goosed the money supply to levels not seen in a decade. Heading into August 1998, money supply was on the rise. Following the Russian debacle, the August ’98 market crash and Long Term Capital failure, investors who had suffered legitimate losses as a result of risk taking activities were rewarded with more cash, as liquidity spiked in September 1998 and then remained excessive through mid 1999.



Source: Federal Reserve Economic Database

Investors partied through all of 1999 and into 2000, pursuing investment strategies that relied on enormous growth assumptions and innovative non-fundamental inputs. Based on our factor models and historical analysis, relationships between standard investment measures such as growth/value, beta/momentum and risk/return, which had remained largely stable between the 1970 to 1998 period, broke down rather dramatically during the 15month period leading up to March 2000

After markets fell in 2000, the Fed tried the same liquidity trick and the money supply surged dramatically during 2001, then reaching levels of excess that had not existed for three decades. While the liquidity helped the economy it did not help the stock market. Today’s levels, though declining are still at thirty-year highs. The fact that the market has not risen over this time is beneficial in a rather round about and painful manner. The market continues to fall, and in order for it to achieve gains that are sustainable, stable levels of liquidity must prevail. In the short term, money supply is a significant driver of equity returns. However, if liquidity is over manipulated by the Fed, in the long term, market participants will adjust their behaviour accordingly and the effectiveness of monetary policy will be reduced.

During other manias and bubbles, in addition to the excess liquidity, there was usually an exogenous event or a displacement of some sort. While one could point to many during this cycle, the two most popular seem to be the productivity miracle (also promoted by the Fed) and the internet era which was promoted as a paradigm shift … which would hence forth change the way we view corporations and stock valuations. A very, very brief synopsis of the resulting business cycle is as follows:

Following the displacement, tremendous opportunities for profit are created and a virtuous cycle of "supply leading demand leading supply" is created and trading profits accrue. Trading profits lead to more trading, which encourages speculation, which leads to a bandwagon mentality, which leads to 'investors seeking to get rich without understanding the process', which leads to opportunities for swindlers, which again increases trading. Eventually, realizing that all the trading is not sustainable, insiders sell, prices start to decline, participants feel distress, prices decline more. For some, bankruptcy follows, which causes even more severe price declines and real panic sets in. The end is signalled by a general feeling of disgust and finally revulsion, as investors turn away and swear off investing in stocks completely.

Today, we are somewhere between panic and creating strong revulsion toward stocks.

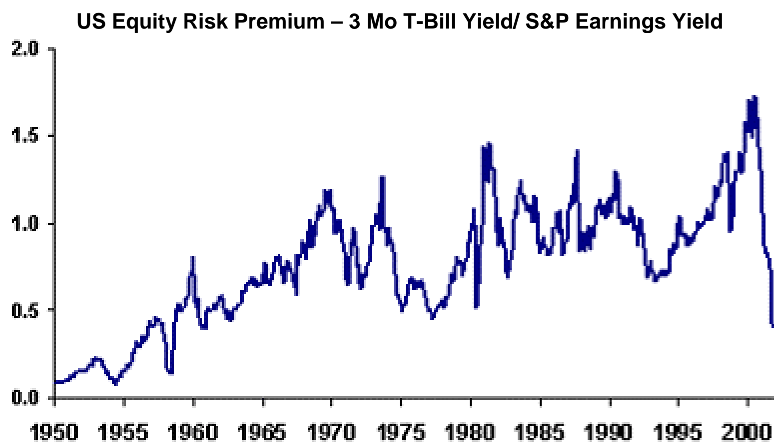
The Light At The End Of The Tunnel?

Bullish investors can take heart by noting that equity returns in 1975, following the 1973 / 74 bear, reached 37% and the year still stands as one of the best on record. Bearish investors, on the other hand, might be recalling that Japanese equity returns (post bubble), as measured by the Nikkei, oscillated between 15,000 and 20,000 for eight years from 1992 to 2000 before breaking down in 2001 and heading towards 10,000. This is where the index stands today, down 75% from its 1989 peak of 40,000. Regardless of market direction, the rationale for integrating non-correlated hedge fund products remains critical to the construction of a well-balanced investment portfolio.

What Valuation Tools Are Left?

Appropriate valuation levels continue to be intensely debated. As we have noted before, analyzing absolute levels of P/E ratios is of little use. A relative measure of earnings yields versus cash or bond yields is much more useful as it allows investors to intelligently compare amongst assets and pursue meaningful asset allocation strategies. With the S&P 500 trailing P/E at 19, the earnings yield is 5.3% and with cash yielding 1.7%, the cash/ earning yield ratio is at 0.32. This is the lowest ratio since the mid 1950s.

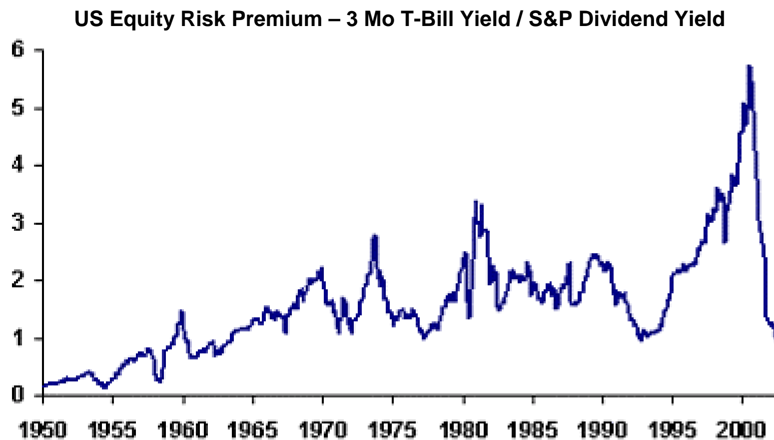
US Equity Risk Premium – 3 Mo T-Bill Yield/ S&P Earnings Yield



Source: Ford Investors Service

However, to be fair, there is still great concern about the validity of earnings numbers and accounting data in general. So, if we are to ignore earnings valuations, why not fall back on the old stand by, dividends. With the current S&P 500 dividend yield at 1.8% and the cash yielding 1.7%, dividends are actually higher than cash rates. Equities last touched these levels in 1992 and 1977 and last sustained these levels forty years ago in the early 1960s. While yields are low by historic standards so are payout ratios. During the latest bull markets, many companies simply chose not to payout a dividend. Companies have room to increase payouts should they choose. At the extreme, Microsoft is sitting on over $30 billion in cash and pays no dividend.

US Equity Risk Premium – 3 Mo T-Bill Yield / S&P Dividend Yield



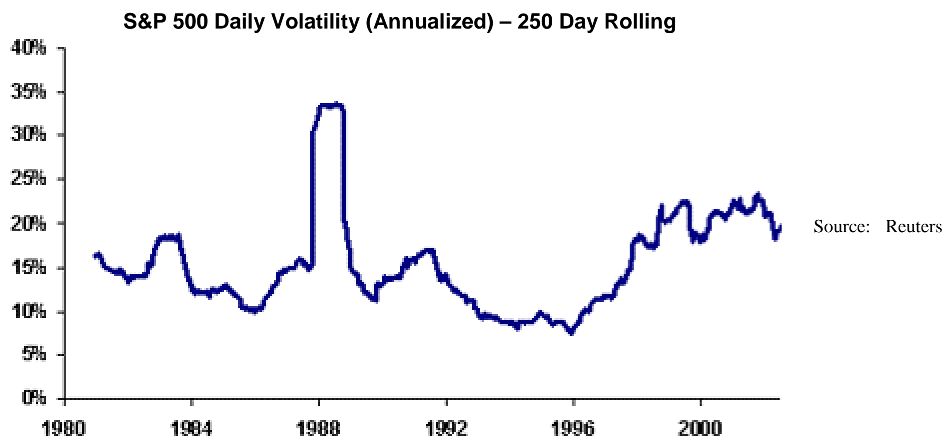
Source: Global Financial Data

In fact, the lack of a dividend payout and the over-emphasis on earnings explains in large part why markets got into this mess in the first place. Dividends are what companies used to distribute to shareholders to prove that their earnings were legitimate. Throughout history, the dividend component was a larger contributor to total equity return than was the capital gain component, save for the last decade or so. The skew towards not paying dividends was kick-started by differences in tax rates. Since capital gains tax rates in the US and Canada are now much lower than dividend tax rates and also, since capital gains are most often deferred, investors had (and have) a much greater incentive to seek capital gains and avoid dividends. Hence, investor focus shifted away from dividends and more towards earnings. Companies paid attention. If they could dramatically grow their earnings, their stock price would be (and was) rewarded. Earnings became paramount and dividends became largely irrelevant. The road to riches lay in earnings growth. In order to assist in the creation of earnings growth, companies began to experiment with alternative methods of accounting. Since earnings announcements were no longer following GAAP, they became harder to monitor, though no one complained.

As investors focused more on stock price appreciation, so did executives. In particular, they began doling out copious amounts of options (to themselves) all tied to the performance of their stock. Again, US tax law and accounting regulations created perversions by allowing options grants to be deducted from taxes owed but not requiring them to be reported as expenses on the income statements. What's worse though, owning options provides an entirely different risk / return profile than does owning stocks. Goosing the stock in the short run provided enormous leveraged gains for executives, while a drop in stock prices produced no loss. Not quite the same experience as a shareholder would have. Executive incentives drifted very far away from investor interests.

Going forward, removing tax discrepancies, re-standardizing accounting rules and realigning executive incentives with those of shareholders would go a long way towards instilling some trust back in the market and providing a solid base for equity valuations.

In the meantime, volatility rules. As we noted in our September 2001 Market Outlook, as long as volatility remains at these elevated levels, investors will have to assume more risk in order to achieve their return targets or if they chose to maintain risk levels that are similar to historic levels, they will have to accept lower returns. Either way, risk adjusted returns will be lower.



We continue to encourage investors to focus on two key concepts: to create and maintain a risk budget within their asset allocation framework and to seek out meaningfully non-correlated products and asset classes to help diversify their portfolios.

As always, we would be pleased to assist you in these endeavours.

Regards,
Chris Guthrie and Arun Kaul

With reference to:

Manias, Panics, and Crashes A History of Financial Crises, Charles P. Kindleberger, 1996
Stocks Are Still an Oasis, Jeremy Siegel, Wall Street Journal, July 25, 2002
Dividends End, Economics Focus, Economist, January 12, 2002