

THE NEW MALAISE

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It was only a little over two years ago that investors seemed willing to believe anything. Entrepreneurs with great ideas (and some not-so-great ideas) believed—and we believed with them—that their ideas would inevitably be transformed eventually, by some benign process, into spectacular earnings.

The Outpouring of Ideas and Technologies

People had ideas for creating new markets for all kinds of things. These markets could be greased almost to frictionlessness by new technologies for information communication. The wave of creativity gave us Amazon.com, Priceline.com, Napster, eBay, and untold others.

Enron was one of the poster children for this era of good feeling. Known as a company full of brilliant people, it offered incentives to any employee who came up with an idea for making a new market.

Many of these companies gave us true gifts. Amazon.com is still making it easier for us to buy books. Priceline.com and its competitors enable us to get airline tickets effortlessly at low cost. Enron created an important market for energy contract trading.

Some basic principles were overlooked, though. It turned out (we should not really have been surprised) that others could horn in on these markets too, driving profit margins down. The spectacular benefits might materialize for customers, but it became unclear how the originator of the idea was to keep all the earnings for itself.

In some cases—notably the Enron disaster—overconfident geniuses assumed smart ideas must still translate into spectacular earnings, but there were a few bumps in the road. To keep anyone from worrying while the pathway got straightened, they decided to apply aggressive accounting gimmickry to make the path look smooth and upward all the way.

We know what happened. These schemes fell like the house of cards they were, revealing that aggressive accounting gimmickry—and its sanctioning by accounting firms, law firms, Wall Street analysts, and others—had become a way of life in many companies.

All Tared with the Same Brush

The problem now is that all firms are being tarred with the same brush. Two years ago investors believed everything; now they believe nothing. Companies with perfectly sound earnings, good prospects, and conservative accounting are being subjected to the same skepticism as companies that are—or were—really out there.

Money managers—especially those oriented toward a value philosophy—seeing the prices of many of those genuinely sound companies fall below their fundamental values, have leapt to buy them, only to find that the market's skepticism is so deep that it continues to drive their prices lower.

Many of these managers feel they have little choice but to keep buying these securities as their prices become—by all normal measures—more and more attractive. But they don't know where the bottom will be. When will investors finally overcome their exaggerated skepticism, as—two years ago—they finally relinquished their rosy optimism?

Fundamentals are Still the Best Guide

In 1934, Benjamin Graham and David L. Dodd wrote the first edition of what is still regarded as the best, and most famous primer on security analysis. In it, they stated that well-grounded prospects for good earnings, at a price that is not too high, are the proper basis for choosing stocks. This is the approach that guided Warren Buffett, and has guided many other successful investors over long careers.

Timing precisely when the market will reward this approach is not part of the strategy. Trying to time the market has proved futile again and again. Capricious trends and herd movements in investor reactions create background noise that—while it never muddies the waters forever—makes short-term prediction nearly impossible.

That is why we advise investors not to be too concerned about short-term results, over time intervals of a quarter or even a year or two. In fact, we advise them that downturns will surely occur, some of them steep, but no one can tell when.

For those who know how to wait, well-executed fundamental investing in the Graham and Dodd tradition inevitably produces good results. Eventually irrational short-term market fluctuations iron themselves out, good quality is reflected in a company's market price, managers who stick to sound strategies add value, and investors are rewarded.