

IN THE NEWS

Have Efficient Markets Resurfaced And Are They Here To Stay?

Has our concept of efficient markets become passé or will the recent downturn restore our faith? The silver lining in the recent market correction in and of itself is that the correction is the essence of an efficient market. For the past decade or more, wise and seasoned analysts and investors such as Warren Buffett and Marty Whitman have reasoned there is little correlation between the intrinsic value of common stocks and their prices. The common complaint was the market was overpriced, but there was very little they could do about it because we have to work with what we've got.

Indeed, last year was the height of Alan Greenspan's irrational exuberance as the average internet initial public offering (IPO) zoomed up 197% from a fair and equitable offering price based on all pertinent data. For many, internet IPOs became a proxy for

how overvalued technology stocks have become. With the average internet IPO trading at three times its reasonable valuation, it became clear these stocks could drop 66% and would just then begin to be valued fairly.

The valuation of the average internet company taken public assumes a 29% earnings growth rate relative to 3% for old economy companies. Thus, in order for these stocks to maintain their post IPO prices, they are required to generate earnings growth rates of 87% a year, well into the future, just to maintain their current market value. The likelihood that even the brightest stars of the internet, e.g., Yahoo, would almost double their earnings every year for the foreseeable future is not particularly good. So, a market correction which would bring stock prices back in line with their intrinsic value would actually be wel-

comed by many industry veterans. Finally, the old-fashioned idea of efficient markets would come into play. Yet, in the recent downturn, the NASDAQ just dropped over 33% and quickly rebounded to be only 25% down from its high in March. This does not bode well for the NASDAQ because eventually there has to be some correction between earnings, value and price. The performance target, dictated by price, requires that these companies achieve three times what is reasonable and realistic. Something must give, and it is likely to be a drop in price. But this time, it needs to be an overcorrection in order for investors to see a resurrection of efficient markets and for risk to again become tangible. This will be the first opportunity for many advisors and investors to use classic investment theory in constructing portfolios, and reason will have

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Cortez And Pastore Join Goldman Sachs To Create and Execute the Firm's Consulting Strategy

Richardo Cortez, the Prudential Securities veteran who ran sales and marketing in its investment management consulting business unit (Investment Management Services), and Peter Pastore, the Salomon Smith Barney veteran who ran Systems, Operations and Administration for its consulting business unit (Consulting Services Division) have joined Goldman Sachs. Though no specific plans have yet been set, Cortez and Pastore will help Goldman Sachs explore how it can capitalize on the industry's evolution toward fee-based advice. The focus is not just on the firm's internal needs but on how Goldman might emerge as a significant player in the new emerging advice business environment. With Goldman's sophistication, they could create for third party users a new, far more

powerful funding vehicle neutral consulting platform than today's wrap fee programs which narrowly focus on just mutual funds or managed accounts. They could provide the raw process technology of advice as a means to harness distribution to other Goldman businesses. They could provide more traditional asset management services packaged as separate accounts. The possibilities are endless, and Cortez and Pastore will be exploring all the options in creating Goldman Sach's strategy around the investment management consulting business model.

Goldman Sach's is one of the world's preeminent investment banking firms and is arguably the single most successful financial enterprise in investment banking, earnings, margins and bonuses within the global

financial services industry. It is highly entrepreneurial and is a magnet for the industry's best and the brightest. It was Goldman Sachs who pioneered the idea of putting high level financial advisors on investment banking teams that could address the personal investment implications of various deal structures with the principals of prospective companies to be underwritten. This almost invariably leads to Goldman managing the assets of the principals of the firms they underwrite.

Goldman maintains a \$50 million investment minimum before their advisory services are engaged. Goldman's advisory services has evolved to four-person advisory teams that include expertise in trusts, estate and income taxation, investments and

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revenue over a period of time. Different revenue streams have different values. Commissions and one-time fees have far less value than consistent, annual investment advisory fees.

4. Valuing your business can be tricky. First, ask yourself what you would reasonably pay for your own business. Then consult with a professional. Management consultant Mark Tibergien of Moss Adams, LLP in Seattle stresses the importance of "free cashflow" as a valuation measure. This is the net profitability of your business adjusted by fair market compensation for you and any other principals. By the way, to prove profitability and determine free cashflow, you have to keep accurate records. Knowledgeable buyers will normally ask for two or three years of financial records.

5. Qualify your buyer. Is the buyer's demeanor, rapport, professional credentials, investment consulting process and philosophy consistent with yours? If it's not a good fit, your clients might decide to leave, and your ability to maximize the value of your business will be limited. Does your buyer have the capital to pay (cash and good credit)? As Bowen points out, "Make sure you are not taking all the risk in a transaction."

Falling victim to the "B Myth" is easy but avoidable with a little awareness and planning on your part. If you really want to own a "business" rather than a "job," then do what Michael Gerber suggests in his book: Think about your practice as if it were the prototype for a network of 5,000 locations. At McDonald's the franchise owners don't flip the burgers, but the franchises have tremendous value because they have installed the systems and policies that turn out a consistent product or service in the

absence of the owner. Some things to think about are:

- Do you have a specific investment process you use that allows you to consistently provide a very high level of professional investment counsel and value to all your clients?
- Do you have technology or access to technology which allows you to provide high level information to your clients?
- Do you have a specific client focus, such as retail, high net worth, defined contribution plans, etc.?
- Is there a division of labor within your practice that allows every team member to excel, resulting in your creating a high performance business team where it becomes the value added?

If you want a more consulting-friendly environment in which to work, you might call me, Mitch Vigeveno, at 1-800-598-3366. ■

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again finally returned to the capital markets. Consider this, Cisco, Microsoft and Intel have a combining market capitalization of \$1.5 trillion, which at that valuation would require minimum returns of 20%-30% for the next 10 years. Under that scenario, they would be nearly the entire market capitalization of the S&P 500 and would be larger than the total U.S. gross domestic product (GDP). This suggests a large and sustained market downturn to where there is actually a correlation between stock prices and their intrinsic value.

In trying to explain the behavior of the market in recent years, the efficient market hypothesis has fallen into disrepute. It is like today trying to make sense out of Graham & Dodd's dividend yields of 45 years ago. It was easy to reason we were in a different place and time, and new and different explanations were required. Behavioral finance theorists believed it was easy to predict future stock movements as they maintained stock prices depended solely on market psychology. The middle ground between effi-

cient markets and behavioral finance was that stock prices are highly correlated with their intrinsic stock value, but sometimes price and value diverged. This middle ground also maintained it was possible to predict stock prices, though it is difficult and cannot be done with great precision.

THIS IS A MARKET WHERE INVESTORS ARE BEHAVING IN AN EMOTIONAL AND NOT STRICTLY RATIONAL MANNER, WHERE ACTIVE INVESTMENT MANAGEMENT STRATEGISTS CAN BE HIGHLY SUCCESSFUL

The more recent middle ground view is that it is possible for a demographic pattern such as the baby boom to increase the demand for U.S. equities and drive up prices for long periods of time. As money continues to pour into the stock market, total market worth – and the worth of the surging internet sector – becomes so huge that there

is no countervailing entity with enough money and market influence to burst the value bubble by betting against them. In essence, the forces of arbitrage are limited, and thus you cannot be sure markets will correct. Harry Dent is the philosophical leader of this thesis.

With the declining numbers of true hedge funds, increasing numbers of individual investors, the growth of indexing particularly among large capitalization stocks, the stock market, in principle, is becoming less and less efficient, and stock prices have moved far beyond their intrinsic value. This is a market where investors are behaving in an emotional and not strictly rational manner, where active investment management strategists can be highly successful. In fact, Dent was so confident he could beat the S&P 500 that he back-tested portfolios with as much as 80% of his assets in short-term fixed income and still beat the S&P 500. Four of the six Dent portfolios beat the S&P 500, and six beat Harry Markowitz's portfolio models.

The danger in there being no countervailing efficient market mechanism in place which would mitigate the demographic market excesses that Dent suggests, is that when those demographic trends run their course in 2009, when the baby boomers' spending reaches its peak, there will be a severe and prolonged economic downturn (depression) that would last until 2023. So there is no such thing as uninterrupted economic expansion that is being suggested by many. In fact, the efficient market hypothesis is essential for the capital markets to work. For example, we have established that internet IPOs were trading at three times their fair and equitable public offering value and that those values could not be sustained

because it required earnings to grow at three times the expected 29% growth rate. When those rates of earning growth (almost doubling every year) cannot be sustained, the efficient market thesis would require a correction in stock prices sufficient to bring them back in line with their intrinsic value. This would mean at least a 66% correction, but because of the psychology of corrections, the resulting panic would likely lead to a significant overcorrection. (Historically the best returns have been achieved on the heels of a market overcorrection.)

The ultimate check-and-balance within the capital markets are earnings which eventually lead to an efficient market. If earnings cannot support market valuations, very simply, values and prices must fall. This is why Warren Buffett and Marty Whitman have been making unusual private equity investments in precious metals and complex turnaround situations, respectively, in recent

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years . . . in a market where no one wants to talk about value, they represented better value than could be found in the equity markets. Thus, the check to the unabridged earnings multiple expansion of the market is eventually earnings, alternative non-financial assets and common sense.

Not many of us would pay \$100,000 for a Buick Park Avenue, why would we pay three times the intrinsic value for an internet stock? This is not to say efficient markets are infallible, because we know in the immediate past that market valuations are

way out of line. What this does say is that in healthy markets there should be a correlation between intrinsic value and market value. When demand for stocks outstrips supply and drives the price of the stock up, there must be corresponding correction in that stock's price if markets are to remain efficient. If internet stocks only correct 33% rather than the 66% (or more) suggested, this tells us the public equity markets command a 100% liquidity premium relative to the private equity market value for the same asset.

Thus, patient money, like shrewd family offices, Buffett and Whitman continue to search for better values in private equity investments until public equity prices came back to earth. As Warren Buffett says, you have to

play in whatever market environment you find yourself, whether you like it or not. Even though stocks had gotten to levels that cannot be sustained, you have to pay it out because no one wants to be the first to sell in a bull market. But when the market turns, there will be no such inhibition to sell, which will result in an overcorrection. Let's all hope the market appropriately corrects, and efficient markets will be here to stay. Yet, in reality, efficient markets are never permanent; at best, they can only be fleeting, which is why our advice has value. ■

What's In A Name? Blue Chips Lose "Brand Power" To Lower-Tiered Firms

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ing of the marketplace and its changing needs which, in turn, the new economy companies are exploiting. To try to compete, some old-line companies are mimicking the new economy companies' advertising in order to look cool, even if it means a radical change in their traditional image. This doesn't work because the old-line companies have not changed anything about their enterprise that would make them more competitive other than their advertising platitudes, and the new image is confusing without substance to back it up. Old-line companies actually have to work harder than ever before to re-invigorate their brands. They have to go beyond what worked in the past to address the changing needs and tastes of a

much more discerning and sophisticated marketplace.

In financial services, just having a robust financial product and service menu and offering trade execution is not enough. Clients want high level advice and value to be added. Thus, a financial services firm's brand is no better than the value it empowers its advisors to add. A compelling case can be made that the only branding that has value in the financial services business is built around a firm's proprietary, comprehensive investment process technology and methodology through which its financial consultants are empowered to address and manage the investment values most important to each investor. If a new economy

financial services firm, say Charles Schwab, were to build itself around investment management consulting and its brand was built on adding value and being responsive to the unique needs and circumstances of each investor, it would clearly be preemptive to an old-line commission brokerage firm which does not have the culture, structure or technology that makes it possible to add value. The consultant addresses and manages the investment and administrative values (risk, return, tax efficiency, liquidity, cost and time structures) necessary in order for the investor to achieve their long-term goals and objectives, while the commission broker's job is complete when the trade is executed and is not accountable for the