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The Voice of the Investment Management Consultant

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Is the Loss of Investor Confidence Necessarily Bad? It All Depends If You Are a Consultant or a Broker

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If you were sailing in open waters and learned a hurricane was just 12 hours away, bearing down directly on you, would you sail away from harm's way or would you set your anchor and try to weather the storm? Today, investors are facing that proverbial hurricane, and many are being advised to "stay the course," or set anchor and weather the storm in a deteriorating bear market. Could conventional wisdom be wrong? Clearly, in a bull market we want to maximize our exposure to the equity markets, so in a bear market why does it not follow that we should minimize our equity exposure?

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Investors have seen the market lose 47% of its value since its peak in March 2000. They have found no solace in self-serving strategists who claimed that the market was "fairly priced" at 11,000, and who, even after a 3,000 point drop through 8,000, maintained that it was still fairly priced all the way down. The truth is that at a price/earnings (P/E) ratio of 35, the market was not fairly priced at its peak, nor is it at today's P/E ratio of 21. This is especially true when you consider that the market's historical average P/E ratio has been 15. If we were to actually experience periods where the market is underpriced (which, according to the law of averages, should be half the time), we would see the market trading at levels substantially below a 15 P/E. Of course, the underpricing of securities would suggest a loss of public confidence in the capital markets, and that has not been the case since 1973-74 when the market lost half its value and took five years to recover. Today, we are at a highly unusual inflection point in investor sentiment. We have experienced the market losing nearly half of its value, and yet investor sentiment is still quite positive. But, in order for the capital markets to regain their health and fully correct, investor sentiment must turn negative to drive stock prices down and P/E ratios to an equilibrium with historical P/E ratios that are consistent with today's private capital market valuations of business enterprises.

When the capital market goes up, there is little reason for concern for individual investors because it feeds their sense of well-being, but when professionals see huge disparities between how companies are valued in the public trading markets and the private capital markets, and see P/E ratios that are out-of-line with historical norms, there is good reason to be alarmed. We have come to a point where all logical explanations of how capital markets work no longer make sense. As a result, much of the industry has moved from investing to speculation without scientific underpinnings. Market leadership, long provided by individual investors who have led the run-up in P/E ratios, is now being challenged by investment professionals who maintain that much further market correction is necessary in order to restore the health of the capital markets. Let's all hope for the greater good that logic and reason will prevail over hyperbole.

We have forgotten that Graham and Dodd formulated their investment theories when stocks were underpriced, dividend yields were 5%, and investor confidence was quite low. While individual stocks may offer a 5% dividend yield, we are a long way from the entire market being characterized in that way and having P/E's south of 15. The loss of investor confidence in the capital markets is an important and necessary free market mechanism that keeps capital markets healthy. By driving down stock prices, market corrections wring out excessive valuations in markets that have become overpriced. Warren Buffet, the most successful investor of our time, made note of excessive market valuations in the fourth quarter of 1999, just before the markets began their downturn in March 2000. Buffet reasoned, "Why would one pay three times more for a company in the public trading markets when one could acquire superior performing companies in the private capital markets in the same businesses at one-third the price?" Buffet's implication was clear. If the public trading market's pricing was

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adjusted downward by two-thirds, it would only then be fairly priced as compared to similar investment opportunities in the private capital markets. Of course, earnings have suffered since the time of that observation, which would suggest an even lower market valuation. At the time, Buffet also announced that he was reversing his traditional investment mix of 70% public equities:30% private equities to 30% public equities:70% private equities until the values of publicly traded companies were repriced at more reasonable levels.

By June of 2000, legendary investment figures such as Warren Buffet, Julian Robertson and George Soros either totally retired from the equity markets or shifted their investment strategies due to excessive market valuations in the public trading markets. Thus, the credence of the time proven P/E benchmark as a proxy for fair market valuation (see "Are Warren Buffet, Julian Robertson and George Soros Trying to Tell Us Something?", *Senior Consultant*, June 2000). The corollary at the height of the market valuation bubble is that the downside to this market is much greater than financial services firms are or were willing to acknowledge.

In a bear market when the market is being repriced and all the trends are down, it is awfully difficult to make investment recommendations that make the investor happy. Yet, in the commission brokerage business model, you don't get paid unless you sell something that hopefully makes money for the investor. If the bear market lasts long enough and the investor consistently loses money long enough, confidence will eventually be lost, and sentiment will turn negative. Financial service organizations have forgotten that a market downturn is a normal and necessary occurrence if the capital markets are to remain healthy. So, it is surprising that a large number of brokerage firms, mutual fund companies, etc., are advising their mass market and retail clients to stay the course, set anchor and weather the storm. This is neither in the investor's nor the advisor's best interest.

Contrary to the desired result, keeping investors fully exposed to the capital markets in the midst of a bear market (where they have already taken a terrible beating) leads to investor confidence being destroyed. The irony is that this triggers the negative investor sentiment necessary for the market to fully correct. The classic bear trap for bulls is a bounce upward in market correction that provides liquidity for sellers getting out and crushes investors getting in, as the correction continues downward. This also crushes investor optimism and accelerates negative investor sentiment that is necessary to reprice the market.

One of the fundamental differences between an investment management consultant and a commission broker is how they view a market correction. Consultants view a market correction as a necessary and anticipated event that keeps the capital markets healthy. Market volatility is what gives the judgment and professional investment counsel of the consultant value. If the capital markets only went up at a double-digit rate each year, then investors would not see the value to be gained by engaging the professional investment counsel of an investment management consultant or any form of advisor, whether they be a commission broker or planner. But, the capital markets don't always go up, and when they do, they don't always rise at a double-digit clip each year. Thus, the need to engage professional investment counsel, especially in a market downturn, is clear. The investment management consultant is well grounded in an investment discipline that gives them judgment on market valuation and pricing. By being accountable for their recommendations, the consultant uses a highly structured approach to portfolio construction that is based on Nobel Prize-winning investment theory and establishes an on-going identity of interest in the long-term well-being of the client. When the consultant makes an investment recommendation, their work has just begun. This is in contrast to commission sales. Once the commission broker/planner/advisor/insurance agent makes their investment recommendation and the commission is earned, their job is completed. Commission brokerage is not structured for accountability of investment recommendations, nor is it designed for the commission salesman to add value through ongoing counsel. Those in commission sales only get compensated when their clients buy something. As a result, any and all language suggesting that the market is overpriced is avoided. This makes the commission broker the primary driver behind the market becoming overpriced. The promise of extraordinary returns creates unrealistic return expectations that drive prices and trading volumes up in an almost self-fulfilling prophecy. This cycle continues until those values are so excessively high that they can no longer be rationally supported by even the most elegant new economy hyperbole. When the market corrects and begins to reprice itself, the commission broker finds it very difficult to sell anything when everything is being repriced at much lower levels.

Market volatility is what gives the judgment and professional investment counsel of the consultant value

There are many hard won lessons learned in a market downturn, especially for those who were not around in 1973-74. The first and most difficult lesson learned when the market is repricing itself downward is that the commission brokerage business is not as commercially viable a business enterprise as we have come to know it in recent years. It is very difficult to build relationships and to add value in a falling market, and commission sales do not engender the skill set necessary for more sophisticated forms of portfolio construction required in a fee-based counsel designed to add value.

In a market correction, consultants advise their clients to minimize market exposure in the midst of a significant market downturn. As a result, they have plenty of capital out of harm's way, waiting on the sidelines to take full advantage of fairly priced or underpriced stocks a few months after the bottom of the market. Just as the consultant may miss by several months when to get out, they may also miss by several months when to get back in. By using more sophisticated means to manage market information such as RowPyn, the consultant adverts far more downside than they would by maintaining full market exposure. It is far more

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valuable for the investor to avoid taking a market beating than the return one loses by being a few months late in getting back in the market. The consultant is as concerned about managing the client as managing their assets.

In commission brokerage, however, the continuing need to foster sales and commissions, even in a market correction, obscures the good judgment of the broker/planner/advisor. Of course, the commission broker would contend, "We are near the market bottom, so why get out now when we have already weathered the worst part of the storm?" However, in this market, the commission broker has forgotten that in order for the market to correct, there must be negative sentiment that drives down prices, which means we are not there yet, and the worst part is not over.

Today, in the current market correction of nearly 50%, we are not even remotely close to negative investor sentiment. A recent Aegon Institutional survey asked parents about their performance expectations for the funds they have set aside for their children's education. The survey found that parents were expecting a 19% return. By extension, the self-cleansing element of negative investor sentiment has not yet worked its way through the market to create more realistic return expectations. This and many other similar surveys of investor expectations confirm that today's market correction is still in its early stages.

So, what is keeping a large portion of the financial services industry from advising their clients to sell as quickly as possible in a market correction? Firms are fearful that if they advise their clients to sell, the investors will not come back again, which was the case in 1973-74 when the market lost half its value and took five years to recover. During that period, trading volume fell to extremely low levels, reflecting a loss of confidence needed to wash the excesses out of the market. From a return perspective, the returns generated from 1975 to 1980 were excellent, but the trading volumes were very poor. Therein lies the disconnect with conventional wisdom. Financial services firms need trading volume in order to stay healthy, yet advisors and investors need a fair market valuation in order to stay healthy.

If the industry would embrace the consulting model, a market correction would become a wonderful investment opportunity rather than a financial tragedy

The period from 1975 to 1980 set up the bull market and market excesses from 1981 to 1999. Those times will come again, but in order for that to happen, the market must first cleanse itself of its excesses. Just as Warren Buffet has counseled against fighting a bull market, so too should we refrain from fighting a bear market. In a bull market, you stay in for maximum exposure, but in a bear market, you want the least exposure possible. Although commission brokerages may not appreciate the lower trading volumes and resulting loss of trading profits, the market correction will force the commission brokerage industry to re-evaluate its business model and cost structure. With a further significant market correction likely, it should be becoming clear that a fee-based advice business model that is designed to add value is far superior to a commission brokerage model where adding value is not possible. If the industry would embrace the consulting model, a market correction would become a wonderful investment opportunity rather than a financial tragedy. Most importantly, the financial services industry would finally exercise leadership that would contribute to the health of the capital markets rather than detract from its health. The difference between opportunity and tragedy is professional investment counsel.

The irrational fear that the commission brokerage industry has toward making sell recommendations has led to the very market excesses that must now be expunged, if the market is to regain its health. There is no question that the market had become grossly overpriced at a P/E ratio of 35, and that it is still overpriced at 21. Commission brokerage is not structured to protect the broker against adverse ramifications resulting from an eventual, necessary market correction. Quite simply, the commission broker must always bare the brunt of a market downturn. The ride up was great, but no one enjoys the ride down. Of course, this could be avoided if the commission broker would embrace investment management consulting and fee-based advice as their principal means of doing business.

This way, the commission broker would get paid to not make recommendations in difficult market periods, and in the process, ends up serving the best interests of the investor. It is the responsibility of the money managers that the consultant engages to rotate in and out of stocks that are providing market leadership, if the market is to regain its health, and accountability is to be engendered for investment recommendations.

The downside risk of the market at a P/E ratio of 21 is far greater than its upside potential. The faster the market goes to a P/E ratio of 15 or less, the better the investment opportunity and the worse the investor sentiment. Although it may sound strange, negative investor sentiment is actually a good thing and ultimately differentiates the counsel of an investment management consultant from that of a commission broker. Only investors with cash on the sidelines and little equity exposure have the presence of mind to view a market downturn positively. Conversely, investors who have taken a beating while maintaining their equity exposure during a deteriorating market environment will generate negative investor sentiment. Ironically, these negative feelings are necessary for the market to reprice itself at more attractive levels.

Thus, investment management consultants must rely on the uninformed or ill-advised investors to create the negative investor sentiment needed for the capital markets to fully correct. The real downside is not that the market fully corrects; the real downside is if the market remains unhealthy and not fully correct until the economy is in worse condition. This scenario could lead to a terrible outcome for both investors and the general economy.

There is a choice that financial advisors must make. As commission brokers, they are contributing to market excesses, while as investment management consultant, they help investors to remove themselves from harm's way, caused by market excesses. In difficult times, financial advisors have to decide if they want to be part of the problem or part of the solution. The quicker the excesses of the market can be driven out, the better the market will treat both the commission broker and the investment management consultant.

Everyone benefits from a full market correction. The capital markets regain their health and, as a result, the economy is not so precariously positioned. This sets the stage for the markets to undergo a recovery and leaves them poised to exhibit outstanding investment performance for years to come. Most importantly, for the tens of thousands of financial services professionals who have less than 30 years of experience, their judgment and professional investment counsel will have been honed by a full market cycle. Negative investor sentiment and a full market correction that reprices and wrings out the excess will be experiences that will forever change the financial services industry. In this laboratory, where it is difficult to make a living in commission sales and where the investor knows it is not possible to add value in commission sales, the unfulfilled promise of investment management consulting will finally be realized. This cannot be mandated. It must be reconciled by market forces. It is in the enlightened self-interests of the consumer, the advisor and the industry that there be accountability for investment recommendations, that a broad range of investment and administrative values be addressed and managed, and that excesses be periodically wrung out of the market in order to maintain the health of capital markets. If we do not deal with excessive market valuations, it could eventually kill the goose that laid the golden egg.

These are difficult times that will test the metal of the financial advisor and the financial services industry. Let's all hope the capital markets regain their health as soon as possible so that the financial advisor and their clients can minimize the pain associated with the market repricing itself at more reasonable levels. Let's also hope that the financial services industry does not try to sell itself out of troubled market conditions by focusing on high commission insurance products or momentum stocks, ignoring the fundamental valuation issues that have greatly contributed to the deterioration of the U.S. capital markets. We need a full market correction with negative investor sentiment. We need market leadership that understands that this negative sentiment is a good and necessary remedy to overpriced capital markets because it drives down prices to levels where investment professionals are able to find attractive values. Now is the time for investment professionals to regain their much lamented loss in market leadership to the retail investor.

Which way will it go? No one knows for sure, but for those of us who have a vested in interest in the long-term health of the U.S. capital markets, let's hope that investor sentiment turns negative and reprices the market at a level that's at or below its traditional P/E ratio of 15. With the market's health restored, we will have plenty of upside upon which to build a healthy industry. If the markets don't fully correct, we will instead be faced with plenty of downside over an extended timeframe that promises to not be pretty. There is no question that the market is overpriced. The only question is when and how long it will take to fully correct. ■

Notes

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