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Wall Street's Two-sided Brain: Are There Any True Contrarians Left?

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Basin Harbor Bears
In the last days of September over three hundred slightly aging, perhaps even dour looking Wall Street types descended upon the beautiful autumn-colored Basin Harbor Club in Vergennes, Vermont. They did so to attend the 37th annual Contrary Opinion Forum, hosted by market historian and money manager Jim Frazer.

As one might expect at a conference sporting such a name, there were quite a number of very bearish presentations.

The first talk came from Bill Fleckenstein, a manager of a short selling hedge fund, with a speech entitled "Spinning Financial Illusions – The Story of Bubblenomics." From him the audience heard a convincing story about a one-off computer and high tech product-buying binge just completed in 1999 – driven rightfully or wrongfully by pre-Y2K upgrading and stockpiling. In Fleckenstein's estimation, this would soon be replaced by a collapse in PC sales in the first quarter of 2000 -- a high tech "nuclear winter" so to speak. Despite Mr. Flekenstein's admission that as a short seller he has accumulated "tire tracks up and down my back these past several years," his speech was as convincing as it was apparently prescient. It preceded by several weeks the profit warnings delivered by both Dell and by IBM that now point to a sharp drop off in their potential sales into the 1st Quarter of 2000. In at least in the latter instance with IBM, during the October 20-21 trading days, the sudden realization of these problems by the market caused a historic one day fall in IBM's stock price.

The audience also heard from Prudent Bear Fund guru David Tice who both at that conference and in subsequent weeks made something of a splash about imprudent debt creation and deceptive company accounting practices. His now somewhat infamous report that specifically focused on the accounting practices at Tyco appeared just a few days after the Vermont conference, and caused a gut-wrenching decline in Tyco's stock. Tice's negative assertions were first denied by company executives, but then fully expanded upon by the popular media as something that was indeed of great concern.

A "Jump Diffusion" World

The tone of both these presentations certainly captured the recent rhythm of Wall Street. As we have moved through the fall months into what may yet bring Fleckenstein's "nuclear winter" scenario, we have been presented time and time again with the following trading pattern for any given day. First there comes the wild early morning flurry in the major averages that, for very little reason, may completely reverse the overnight machine-traded trend. Then there comes the "disaster de jour" as a given stock which made a negative announcement of any sort the prior afternoon must finally open in regular trading hours and test whether its post-hours Instinet/Island decline was in fact real. Then there comes the midday bevy of IPOs that serve to reinforce the faith of the bulls in the overall market as these hot new stocks vault stratospherically higher in their first few trades. And soon we near again the late afternoon hours when the roulette wheel is searching for the next day's impending disaster. Somewhere in between, during the hours of noon to three, absolutely nothing happens except a big yawn and a long lunch. A histogram of the trading activity would show the preponderance of every day's activity moving increasingly toward the open and the close.

In options parlance, one would refer to this market as being increasingly one that demonstrates classic "jump-diffusion" tendencies. This is a fancy way of saying that in lieu of a market where volatility is relatively constant over a period of time, the volatility of volatility is very high. A stock may languish or slip in quiet trading for several days, and then struck by a news announcement, drop 25% without significant trading taking place at intermediate prices, just as Land's End stock did during the trading day of November 11th, or Gillette, Raytheon, Avon, or Mattel did before it. Every stock is instantly reevaluated and severely punished. The preconception that one will always have the opportunity to dutifully protect a long position with an appropriately placed stop-loss order has recently been shattered.

The Wonder of the Two-Sided Brain

But if Fleckenstein and Tice seem to have gotten it very much right on a "micro" basis – spotting in advance several potential disasters waiting to happen -- they have to date also gotten it very much wrong on a "macro" basis. Despite the profit warnings and the ever-present disaster de jour, the NASDAQ as a whole has vaulted over 20% higher since late October. Even when Microsoft was subsequently dealt a severe blow in its antitrust case, not one Wall Street firm issued a sell recommendation on it, but instead five firms put out a "buy." People seemingly understand bearish news and are disappointed by it, but at the same time they somehow cannot allow themselves to actually turn bearish. We will refer to this phenomenon as the "wonder of the two-sided brain."

Indeed, even at a conference that was supposed to be for "contrarians" and "bears" back at Basin Harbor, it was noteworthy that in a show of hands, approximately 60% of the audience still believed that equities would be higher in one year's time. It was also noteworthy that for a conference dubbed contrarian, the sponsors offered an agenda that seemed to have been purposefully seeded with presenters who were anything but bearish. Following Fleckenstein and Tice, we heard from stock-picking value mavens John Neff and Chuck Royce who by the nature of their business approach are always bullish on something. And we heard from G. Edward Noonan, President of an advisory firm called Contravisory Research Corp, who made a presentation entitled "The Bullishness of Bad Breadth." The thesis here was that the average stock had become so down trodden since April 1999 that only 8% of the stocks that his firm monitored could still be labeled in an "established uptrend." This was an apparent twenty-three year low in his analysis, and if only 8% of the stocks were still in an uptrend, then his thinking went, the broad market could not possibly be overbought or making a major high. No, it was statistically more likely (to him at least) that we should be closer to a major low.

Americans adore statistical analysis – whether it be on the baseball field with ERAs, RBIs, pitches thrown, or strikeouts made, or whether it be on Wall Street in the market's TRIN, TIC, volume, or breadth. But here we had a conference of contrarians who didn't seem to want to be very contrary at all, listening to an analyst spin a bullish story out of bad market breadth. Indeed in a more formal poll at the beginning of the conference only 20% of the audience predicted that the Dow Jones Industrial Average would be below 9000 in six months. 49% saw it above 11,000 in one year's time. And by the end of the conference, while the number of bears had grown a bit, 60% of the audience still believed that the DJIA would be trading above 9000 one year hence.

Now when the contrarians can no longer bring themselves to be bearish after a 17-year vault to ever-higher highs and to statistical levels of valuation that are without precedent, does that tell us something? When they listen intently to a bearish throng of convincing speakers, but then blithely remain bullish nonetheless, is this cause for concern? When the very panel of speakers at a contrarian conference is stacked with more bullish types than bearish ones, what the hell is going on? Perhaps there really *is* some sort of disaster waiting to happen out there. This audience clearly thought of itself as "contrarian" and was proud of this fact (by the mere fact that they had all traveled to this remote locale to attend), but as attested by the group's very voting, they were clearly anything but contrarian as a whole. Each individual may have had a certain contrarian streak, but as a herd they were all still quite bullish.

A More Recent Gathering of Bears

This effect was most recently observed in a different manner at a second gathering of market sceptics – *Grant's Interest Rate Observer*'s final fall conference of the millennium, held atop the St. Regis Hotel this past Wednesday. At that conference, Jeremy Grantham of the money-management firm Grantham, Mayo, Van Otterloo & Co. made perhaps the most compelling and eloquent presentation of the statistical case for a major bear market. We will reiterate the gist of his presentation here.

As a matter of background, Grantham first argued that by the very evolution of our mutual fund world into more and more specialized fund functionalities, we have slowly been moving into an environment where the average fund manager is far more concerned about "benchmark" risk than true "market" risk. If a fund manager is handed a pot of money and told to go at it, the manager has very little to gain by investing that money in any other fashion than as detailed in the fund's prospectus, and the manager often feels compelled to invest it fast. If he or she were to hold back in committing funds to the market or over-allocate into another asset class that might be deemed temporarily more attractive, the manager would be open to charges of "style shift." The fund would risk the potential loss of its customer base and the manager would face overall greater career risk. " Managers are not paid to think anymore, they are paid to invest," Grantham argued, and because of this, "traditional arbitrage pressures related to the concept of 'relative value' investing are weakening with time instead of getting stronger. The markets are becoming less efficient rather than more so." If a given asset class suddenly falls dramatically out of favor, there is no one immediately culpable for this at the fund level. Without culpability in managing other people's money, there is by definition more risk in the overall system (as well as of course a greater opportunity for a few to profit from distortions driven by the mob psychology).

Three Types of Environment

In addition to this subtle shift in the fund management world, Grantham has broken down modern equity history into various blocks of time. These are in his mind: trending bulls that last more than fifteen years; periods where we have consistent reversions to the mean (and where value managers thrive); and 4-year finale blowoffs that tend to end quite badly. His specific assertion is that every major bull market back to the inception of the Dow Jones that has lasted for more than 15 years has ended as follows:

Step 1) A 4-year out-performance of the Blue Chip high cap stocks vis a vis secondary small cap stocks.In 1925-29 this was an out-performance of some 136%; In 1968-72 this was an out-performance of some 46%; and in 1995-99, this has to date been an out-performance of some 104%.

Step 2) In the 4th year of this 4-year finale blowoff, the secondary stocks cannot even get their sign right. In 1929 Blue Chips were up home 27% while small caps were down 21% even before the October '29 crash; In 1972 Blue Chips were up some 13% while small caps were down 9%; and in 1999, Blue Chips are up 18% while small caps are down some 16%.

Step 3) In the final months of the blowoff, there is extreme narrowness. The percentage of the overall market that is under-performing the broader averages by more than 10% is extremely high.This occurred first in September 1929; it occurred again in June 1973; and it started to occur most recently from April 1999 onward.

A Further Focus: "Price to 10-Year Average Real Earnings"

Now perhaps a millennium of data that yields a three-step pattern such as this on just three occasions does not concern the e-trading community, but it certainly does concern Grantham. He is further concerned that the current "Price to 10-Year Average Real Earnings graph" (depicted below) shows U.S. valuations that are not only at the highest levels ever recorded, but they are so by 2.5 standard deviations. Price to 10-year average real earnings currently stands at approximately 37x1 versus a long term historic mean closer to 14.5x1 and a one-standard deviation level of approximately 17.5x1.

So he quite regularly will ask an audience looking at this graph of Price to 10-Year Average

Real Earnings, "how many in this room think that *at some point* in the next decade this graph will revert at least to the one- standard deviation level of 17.5?"

To this question, he will quite regularly receive a large majority of "yes" hands.

"Now how many in this room think the Dow Jones will be modestly higher in the next ten years?"

Again he gets a positive show of "yes" hands.

But then the boom falls. He quickly points out that corporate profit margins have had a long term mean of slightly under 6% (currently running around 7%), and that sales growth has a long term mean of just 1.8% and has not been particularly more ebullient than this in recent years. Using these assumptions, and a 17.5x1 Price to 10-Year Average Real Earnings level, the DJIA would be trading close to 3600. Even if one assumes that sales growth remains permanently high at 4% as opposed to the historic 1.8%, the DJIA would still most likely reach 7300.

Seemingly, the two-sided brain can look at an obvious statistical extreme and admit that it is likely to revert back toward the mean, but the other side of the brain cannot conceive of a dramatic bear market. This is the same phenomenon that we saw in Basin Harbor. People can listen and nod at the logic of bearish speakers such as Fleckenstein or Tice, but they cannot bring themselves to truly conceptualize the ramifications of what it is that is being said. Perhaps they have already heard the bearish story too often – never with any lasting bearish results. As a result, they now just assume that the bad news will somehow get factored away, and that the market will generally survive with a small nick to its armor as opposed to a full bloodletting.

While Grantham can easily model why Price/Earnings ratios are currently so high – driven in his mind by strong consumer confidence, the 5-year rolling stability of GDP, perceived low inflation, and the relatively high current level of real profit margins -- he goes on to state: "explaining them in the present does not also make them justifiable longer term. When you get a two standard deviation event as we have now, you have by definition created a bubble. And regardless of what market is involved, all bubbles inevitably give back all their gains, if not more, when they revert to the mean."

Other Views

Grantham was joined in his overall bearishness by others in the Grant's parade of speakers, inclusive of luncheon speaker Seth Klarman, renowned value investor of the Baupost Group, who termed Internet investing as "something visceral rather than rational. People want to touch the future."

Andy Carter, meanwhile, a man who has spent his entire career analyzing the bond market and is currently the chief executive officer of Hyperion Capital Management, bemoaned the never ending degradation of paper money since the creation of the Federal Reserve, pointing out that even a modest 3% inflation level compounded over ten years degrades a currency's value by some 37%. He termed the current 6.1% yield on the long bond, "simply not sufficient to guarantee against this tendency over a long period of time. Greenspan may be viewed as a good Fed Governor for the moment, but all you need to see is the chain of trust in government to be broken *once* by any subsequent Fed governor, and the ramifications to one's portfolio would simply be horrific." One presumes that he would be somewhat more favorably inclined to TIPS (Treasury Inflation Protected Securities) until he further explains that that the "Bureau of Labor Statistics has already implemented four-fifths of the Boskin Report to lower the released CPI calculation by approximately 1%." Wage pressures by his calculations are already running closer to 6.9% rather than the government's Employment Cost Index of 3.1%.

Trouble to Come From Abroad

Even Barrie Wigmore, a former partner of Goldman Sachs and the author of a recent text on the 1929 Stock Market Crash, could not avoid being a bit cautious. Despite trying to sound somewhat bullish by pointing out all the *dissimilarities* between 1929 and 1999, he also suggested that something usually comes along that is unforeseen – "usually from abroad" – to upset a bullish environment. Listening closely to Carter, it was clear that he viewed this potential surprise to be higher global interest rates, driven specifically by a Japanese yield curve that in Carter's estimation "will be above 5% across the curve in less than two years."

Kieth Bronstein, a trading expert from TadeLink LLC, concurred. He painted a horrific picture of the current environment facing Japanese Government Bonds, calling Japan a "demographic time bomb" that already has diminished tax receipts and seen ever-increasing entitlement payments. He cited their Postal Savings Program having already lost $149 billion in diminished deposits in 1999, with a further $100 trillion to flow out of it between now and 2001. And he referred to the Japanese Bank Deposit Insurance Corporation as "already running out of funds" after only being in existence for a nominal period of time.

"Japan will either go the way of growing their way out of their problems, or imploding a la Italy," Bronstein offered. "Either way, rates will go higher."

In the mind of Michael Steinhardt who also spoke at the conference, any such development would only tend to exacerbate current merchandise trade problems with Japan that he views as the U.S. market's most serious macro imbalance. "This is something that is simply not going to be easy to deal with," Steinhardt stated, "and if it gets further out of control, it is worrisome that the system simply has fewer liquidity safeguards than it used to." Pressed by what he meant by this latter remark, Steinhardt bemoaned the overall lack of depth in today's markets. "If a stock drops on news, there is often no one to buy it. We are in the process of destroying the old specialist system, and few institutional desks exist anymore that will step up to the plate and buy a given stock in free-fall. This lack of liquidity and our dependence on foreign capital remains a twin-edged source of much concern."

A final question from the audience.

"Mr. Steinhardt, would you share with us a few of your best stock pick ideas?"

Somehow, the two-sided brain of this gentleman in the fifth row just still doesn't quite get it.

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