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PDV *OBSERVATIONS*

A Tale of Two Markets: A Bear Dressed Up in Bull's Clothing

The Dow closing above 10,000 certainly gives off the *misleading* impression that all is peachy with the stock "market." If you think the "market" is doing great, think again! *It depends entirely on how you define the "market."* You would think an appropriate definition would encompass the vast majority of stocks, but the media and press have for some time now confined the definition of the "market" to a very narrow group of stocks.

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The truth is that the vast majority of stocks have been in a ***bear market*** for over a year now. This may come as a shock to many investors, since more and more people have crowded into a few big-cap stocks that have been soaring. They therefore haven't felt the pain yet.

How can you tell we've been experiencing a bear market? Most stocks are well off their highs reached in the past 18 months. On a typical day, many more stocks are declining than advancing, and stocks hitting 52-week lows are far outnumbering those hitting 52-week highs. In addition, perplexingly many companies experiencing *better-than-expected* operating results continue to see their stock prices stagnate or decline. This group of companies includes, among others, real estate investment trusts, homebuilders and small technology companies. This is the essence of what a bear market looks and feels like.

If we sound like a broken record, it's only because things haven't changed much in the past few years. After small stocks greatly outperformed big-cap stocks during 1991-93 (when predictably greed meant small stocks were all the rage and fear meant you couldn't give big-cap stocks away), the big stocks came roaring back and have trounced their small brethren since 1994. Each year since then, gains have become concentrated in fewer and fewer stocks. This small part of the market has masked the true nature of the underlying bear market, because of the spectacular gains enjoyed by the highly visible stocks in this narrow segment. Let's see just how much these two tiers of the market have diverged.

Broad Market

This segment of the market comprises most stocks, but excludes big-cap growth stocks and internet stocks (a.k.a. "internuts"). This is the part of the market that you don't hear the media discussing much, because people are not attracted by stories talking about stocks that are either going nowhere or declining. And yet paradoxically, this segment is important in that it comprises the vast majority of publicly traded stocks, including small and mid-sized growth stocks and value stocks of all market caps.

Just how poorly has this market segment performed? The New York Stock Exchange "advance/decline" line measures the number of stocks rising versus dropping on any particular day. The March 25, 1999 edition of the L.A.

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Times indicated the cumulative advance/decline line recently sank to new lows and is now ***worse*** than those reached last October, when various market indices dropped from roughly 20% to 40% peak to trough.

The March 29, 1999 edition of Barron's indicated that over 60% of the roughly 7,200 stocks making up the broad market ***lost*** money last year. Excluding the largest 25 NASDAQ stocks, the remaining roughly 4,475 stocks in that index averaged a 4% loss last year.

The April 1, 1999 edition of the Wall Street Journal provided further sobering news. The American Stock Exchange, Value Line and Russell 2000 indexes lost 4.2%, 18.1% and 17.3%, respectively in the past year. The Russell 2000 is now trading *below* its value on January 1, 1998 (a full 15 months ago).

Big-Cap Growth and "Internuts"

In reality, there are no more than 25-30 stocks (out of a universe of over 7,000) that have really sizzled in the past 12 to 18 months. They are the ones that have commanded the media's attention, giving the misleading impression that we are still in the midst of a bull market. ***They have helped dress the bear up in bull's clothing!*** Most of these stocks share a common trait: excessive valuations that range from the irrational to the ludicrous.

We've seen this movie before. Whether it was tulips in the 17th century, big-cap growth stocks in the early 1970's (a.k.a. the "*Nifty-Fifty*"), oil and technology stocks in 1980's, Japanese stocks and real estate in late 1980's (a decade later, and Japan's market is still flat on its back trying to recover from the hangover), the biotech stocks in the early 1990's, or emerging markets (a.k.a. submerging markets) in 1997-98, these bubbles all ended with a crushing thud. So will the current love affair with the new generation's ludicrously overvalued big-cap growth stocks (a.k.a. the "*Nifty-Thirty*" Part II) and the "internuts."

To illustrate how "narrow" this market advance is, consider the March 29, 1999 issue of Time reported that just 15 out of the 500 stocks in the S & P 500 index accounted for 52% of that index's gain last year. The March 29, 1999 edition of Barron's indicated that just 25 big technology companies (out of a group of around 4,500 companies making up the NASDAQ) accounted for 93% of the gain in that particular index in 1998! The other 4,475 stocks missed the invitation to the party.

Incredulously, this year the disparity between the select few and the vast preponderance of the general market has worsened. The April 1, 1999 edition of the Wall Street Journal related that just 21 out of the 500 stocks making up the S & P 500 index accounted for *all* the gain in that index through last Tuesday, with the other 479 stocks breaking even. Microsoft and AOL by themselves accounted for one-third of the gain! Moreover, only 3 of the 30 Dow stocks contributed to over 50% of the Dow's gain this year.

How crazy has this trend favoring a narrow group of internet and big-cap growth stocks become? Anecdotally, evidence indicates it has become totally irrational. ***For example, a well-known value mutual fund manager recounts how an analyst at a brokerage company kept raising his price target on an internet stock, after the stock pierced his price targets repeatedly and surprisingly quickly each time. Eventually, the analyst gave up setting price targets, saying there was no price too dear to pay for this stock. With advice like this, who needs enemies?***

We can also look at the anecdotal evidence, widely reported in the press and by the media, that many have abandoned their jobs to trade internet stocks online, often using margin. Just this morning, the April 1, 1999 edition of the Wall Street Journal recounted how it was probably online individual traders who catapulted a comatose penny stock up 37,636% (no, it's not a typo) during a recent trading day because it was mistaken for an internet stock that had not even gone public yet and could not be traded!

In fact, this trend of using margin to trade internet stocks even alarmed the brokerage companies, many of which never met

a margin loan they didn't like. This is because generally brokerage companies love to make margin loans to their customers because they are extremely lucrative.

A few brokerage companies recently raised their margin requirements, effectively requiring more equity or down payment from their customers and reducing the amount of the margin loans. The brokerage companies reluctantly took this step, after some internal studies they did revealed the widespread use of margin by their customers in trading the "internuts." These studies concluded that many customers could be potentially wiped out if the price of the "internuts" serving as collateral for the margin loans were to drop 25-30%, leaving the brokerage companies potentially "holding the bag." As even casual market observers undoubtedly have noticed, intraday price swings of such magnitude either way for internet stocks are common.

What can we say about the riskiness of the stocks in this narrow market segment using good old-fashioned valuation measures? Well, most of the internuts have no earnings, so p/e ratios are meaningless. We can use price-to-sales ratios, but most calculators don't accommodate numbers that large. *What they lack in earnings, however, they more than make up with hype.* Since the hype factor is so huge, I suppose they may be considered undervalued on a *price-to-hype* ratio! Maybe that's why Wall Street analysts consider the internuts undervalued and opine that no price is too dear to pay for them.

With respect to the narrow group of about 20-25 big-cap growth stocks that actually have earnings, they average around a 50 p/e ratio on trailing earnings with many in the 40 to 70 p/e range. When you figure that earnings have been inflated by stock options hiding compensation expenses from the income statement and "big-bath" write-offs, the actual p/e ratios are even higher. Many of these high-quality companies are now selling at p/e ratios twice or three times their historical averages. There's little doubt that in time, price and value will converge, decimating these stocks.

Excessive or uninformed risk-taking the past few years has been amply rewarded. Prudence has resulted in regret for some and opportunity costs. This won't always be the case. If you own these stocks directly or through mutual funds, you need to be aware of the huge risks involved. It's better to be early than sorry.

Warren Buffett: Revered and Ignored At the Same Time

As one of the greatest investors of our time, Warren Buffett is revered by individual and professional investors alike. ***It is therefore most ironic that investors are pouring en masse into the big-cap growth market segment from which Mr. Buffett has been selling stocks.*** In fact, it has been a very long time since Mr. Buffett has sold such a large amount of stocks. Let's examine what Mr. Buffett has been up to lately.

Mr. Buffett released the 1998 Annual Report for Berkshire Hathaway over the internet several weeks ago. Unlike last year, he made no statements about the valuation of the general market, but his actions (substantial stock sales) spoke much louder than any words. His stock sales are particularly illuminating about his judgment of the riskiness of the big-cap growth market segment he focuses on, as Mr. Buffett's favorite holding period for equities is "forever" and he abhors recognizing capital gains that trigger taxes. What exactly was the scope of his actions?

First, he sold off portions of some of his long-time holdings, like Freddie Mac, Disney and Wells Fargo.

Second, even before Berkshire's recent merger with General Re closed, he asked General Re to begin selling its entire equity portfolio. A relatively short time later, General Re had sold its entire positions in about 250 stocks and incurred $935 million in taxes! This meant the capital gains greatly exceeded $935 million (since the corporate capital gain tax rate is 35%), and the value of stocks sold was greater

still (because the cost basis for the stocks was presumably considerably above zero).

Third, Berkshire's Statement of Cash Flows indicated that Mr. Buffett sold about $3 billion worth of stocks and other investments, generating over $1.8 billion in taxable capital gains.

Fourth, I believe one of the motivations behind Berkshire doing the merger with General Re was to reduce the equity exposure of its investment portfolio without the related adverse tax consequences. General Re was essentially an over-capitalized reinsurance company with a lot of fixed income securities in its investment portfolio. By combining the two companies, Berkshire got access to a lot of non-equity investments which Mr. Buffett could reinvest into equities when appropriate, while *reducing* the equity exposure of the combined investment portfolios of the two companies for the immediate future.

As of the end of 1998, Berkshire's balance sheet showed an uncharacteristically high cash balance of over $13.58 billion versus $21.25 billion in bonds and $39.76 billion in stocks and other investments. This is because Mr. Buffett is having trouble finding investment bargains *in the market segment he focuses on*. How do we know this segment consists of the big-cap growth stocks?

With a book value of over $57 billion, Berkshire's investments must be huge in size to materially affect its operating results and net worth. As a practical matter, Berkshire could not invest in small or mid-cap stocks even if Mr. Buffett found them attractive.

Given Mr. Buffett's affinity for growth stocks, he is relegated to looking at big-cap growth stocks, precisely the very market segment that's absurdly overvalued right now. While Mr. Buffett is willing to pay a reasonable price for high quality companies, he won't over pay. His unwillingness to put Berkshire's considerable cash to work seem to confirm that the big cap growth market segment he focuses on offers no attractive bargains at this point.

Indeed, his sales in this segment appear to signify something very ominous, when you consider that Berkshire's stocks would have to decline greatly before Berkshire would come out ahead by taking profits and paying taxes (because of the low cost basis for these stocks). Presumably, Mr. Buffett would not have taken a 35% tax hit unless he felt some of Berkshire's stocks were considerably overvalued and ran a substantial risk of plummeting, as price heads down towards business value.

Since it would not make sense for Berkshire to shop among small or mid-cap stocks, I believe Mr. Buffett's inability to find attractive stocks is not a comment on whether attractive small and mid-cap stocks exist. In fact, here at PDV we continue to find many undervalued and attractive small to mid-cap stocks whose prices have been unduly depressed by the bear market. We continue to invest our clients' funds for the long term in these areas.

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