WINTER 1997 VOLUME 3:4

# PDV *OBSERVATIONS*

## Asia's Miracle Turned Debacle: Now you see it, now you don't

One moment it's a miracle, the next a debacle. As recently as twelve months ago, the Asian economic "miracle" was grabbing all the headlines. Many of the countries in Southeast Asia had enjoyed substantial economic growth over the past few years, offering investors and speculators alike the *apparent* opportunity to invest in and potentially profit from this growth *on a sustainable basis*. Attracted and seduced by the prevailing sentiment at the time that the economies of many of the countries in this region were going to grow to the sky, investors tripped over one another to get on this "economic train before it left the station".

There was only one little problem - this growth was largely built on a shaky foundation that was unsustainable and eventually crumbled. The Southeast Asian economic miracle was propped up by irresponsible monetary policies, hyper-inflated asset values, rampant crony practices, nepotism (at least in the case of Indonesia) and serious over-capacity financed by imprudent lending practices.

*This insatiable investment binge in Southeast Asia was propelled by factors typically present with investment manias and bubbles.* These include, among other things, the promise of endless growth and prosperity, the opportunity to make quick profits, and the comfort in knowing that there was an overwhelming consensus prevailing at that time that investing in Southeast Asia was "the smart thing to do". This consensus gave investors the ***illusory*** feeling of certainty that investing in Southeast Asia was a "sure thing".

Herd-following money managers also did their clients a disservice by participating in lemming-like behavior and perpetuating the illusion. They couldn't "afford" to be out of these markets, because their competitors were also investing in them.

As is often the case, those investment professionals who resisted the prevailing fads, trends and sentiment ultimately proved to have helped their clients over the long run (***even though the cost of doing the right thing was to look dumb in the short run as the Southeast Asian markets marched relentlessly higher***). Astute investors in the region, such as Marc Faber, who is a well-known Hong Kong based investment manager, saw the writing on the wall and issued bearish warnings repeatedly. Chalk another one up for contrarian thinkers. Few paid attention, since why spoil a good party? Risks, what risks?

The relentless bull markets in this region made investors complacent, and they became quite oblivious to the excessive risks they were taking. Blinded by the prospect of a continuation of the substantial returns generated by these markets over the past few years, investors forgot to pay heed to the other side of the investment equation, namely the level of risk assumed to achieve that return. ***We cannot help but wonder aloud whether the same thing has been happening to those investors who continue mindlessly to buy the stocks of a narrow group of overvalued big cap U.S. companies with multinational operations.***

As the currency of many of these Southeast Asian countries sinks to new lows against the U.S. dollar, these countries face the real prospect of prolonged recession, decapitated asset values, soaring interest rates and inflation, meltdown of their financial system, rising corporate bankruptcies and potential social and political unrest.

While the initial problems emanating from Thailand were considered localized and therefore largely ignored by U.S. investors, the subsequent

*Inside This Issue:*


- **Asia's Miracle Turned Debacle p. 1**
- **Dichotomy Between the Intellect and the Gut: Some things will never change p. 3**

spreading of this "Asian contagion" has finally grabbed the attention of U.S. investors.

What do all these developments in Southeast Asia mean for the U.S. economy and corporate earnings? Wall Street, though initially acknowledging some potentially adverse impact on U.S. corporate earnings (which ultimately determine stock prices), felt the impact would be minimal. The pundits on Wall Street reasoned that the volume of U.S. exports to the Southeast Asian region as a percentage of the U.S. gross domestic product was not that significant.

Here at PDV Financial, we find any analysis that measures the impact of the developments in Southeast Asia on the U.S. economy solely by the amount of U.S. exports to these countries to be misplaced. Why? Consider the following hypothetical example, which has become common given the increasingly inter-connected global economies and multinational companies.

Let's say a company in Thailand has been importing a certain volume of goods from a company in the U.S. With Thailand's currency (the "baht") depreciating, it becomes more expensive for that Thai company to buy U.S. goods. It therefore cuts back on its imports from the U.S. company. In this simple example, is the only *potential* damage to the U.S. company the reduced volume of goods shipped? No.

At a minimum, there will be an additional negative impact on the earnings of the U.S. company if the reduced shipment of goods is to be paid in Thai currency. This is because the depreciated currency has to be translated back to U.S. dollars, resulting in fewer U.S. dollars in sales for the U.S. company. But perhaps more significantly, lower demand from Thai consumers because of high interest rates and recession might cause the Thai company to order less from let's say a European company as well. If that European company also happens to be a customer of the U.S. company, demand is further reduced.

A more pessimistic, but in our view an equally flawed, analysis has recently emerged from the Wall Street pundits, projecting that the troubles in Southeast Asia will cause a severe protracted recession in the U.S. They focus on the reduced demand for U.S. goods and services from the Southeast Asian countries as well as the fact that the reduced sales in many cases would be paid in cheapened local currencies that must be translated back into expensive U.S. dollars before being reported on financial statements.

Because of these factors, they anticipate that corporate earnings would be decimated and cause a market crash in the U.S. Also, there's widespread concern that the Southeast Asian "tigers" will take advantage of their cheapened currencies to flood the U.S. with cheap competing products, thereby further pressuring profit margins and decimating U.S. corporate earnings.

We think the truth about the economic impact of the Southeast Asian "miracle turned debacle" probably lies somewhere between the relatively benign impact suggested by the analysis based on volume of exports, and the catastrophic projections discussed above. First, there is anecdotal evidence that some companies in the Southeast Asian region are having difficulty securing the necessary bank credit and letters of credit to support increased exports to the U.S. Therefore, the export threat may presently be exaggerated.

Also, the Southeast Asian debacle will not be *uniformly* negative for all U.S. companies. Each company needs to be analyzed individually to gauge the potential impact from the Southeast Asian fall-out. Consider a U.S. company that does most of its manufacturing in Southeast Asia, but sells its products domestically and gets paid in U.S. dollars. In this situation the company will actually ***benefit*** from the Asian debacle. Why? Because the cost of producing the goods, including major expense items such as labor and costs for materials procured abroad, will drop substantially. And yet its sales will continue to be denominated in U.S. dollars, thereby widening profit margins.

Where does all this leave U.S. investors? Our advice is to avoid that narrow group of multinational blue-chip companies that have been most responsible for sustaining the U.S. bull market over the past few years. During that period, the stock prices of these companies have been pushed up to ***absurdly*** overvalued levels because of a cheap U.S. dollar and their exposure to foreign growth.

Now that these trends have reversed, common sense would suggest that Wall Street would acknowledge the vulnerability of these companies. But Wall Street, which relies heavily on some of these companies for lucrative underwriting and other business, has come up with an entirely different set of

rationalizations why the reversal of the currency and economic growth trends won't unduly hurt these companies. Herd-following money managers, who have been imprudently taking ***excessive*** risks to chase returns by being heavily invested in these stocks, have every incentive to prop the price of these stocks up. They have therefore reinforced these rationalizations with vigor.

Here at PDV we are somewhat baffled by this. If the weak dollar and strong export potential to the formerly fast-growing Southeast Asian countries helped increase the earnings of these multinational companies and sustain their *outlandish* valuations in the past few years, then why wouldn't the reversal of these trends *adversely* affect these same companies going forward? It is important to note we are not suggesting that all multinational companies with substantial foreign exposure be avoided. It's always a question of valuation, and some multinational companies continue to be attractive. As always, critically question prevailing consensus opinions, do your homework and select stocks on a company-by-company basis.

## The Dichotomy Between the Intellect and the Gut: Some things will never change

There have been many reasons given for the strong performance of the U.S. stock market over the past few years. These range from the sensible to the disingenuous. One of the reasons often cited is that the "average individual investor" has learned to take a long-term investment approach. They buy dips and resist selling on the way down, thereby supporting the market.

Advocates of this viewpoint point to the increased access that the average investor has to information, investment tools, professional assistance and the like than in the past. They further highlight the fact that during the several sharp market corrections we've had in the past few years, there was no evidence of panic selling by the average investor.

We agree that the average investor has become much more sophisticated and informed. But we think it may be fallacious to assume that greater knowledge, expertise and information necessarily means more rational behavior. The truth of the matter is many professional money managers and security analysts who have good knowledge and great resources nevertheless engage in precisely the same short-sighted investment behavior that individual investors have been accused of in the past. The reason for this is that investment behavior is influenced as much by one's emotions as factors such as knowledge and expertise.

Money is a highly emotional issue for most people. ***When it comes to investing money, the asymmetric emotions of greed and fear can be so powerful as to overcome rationality. In other words, it's quite easy and common to find otherwise highly intelligent people engaging in irrational investment behavior that they later regret because they become distracted by their emotions.***

It's human for people to be fearful when they see their "paper" net worth drop. One's intellect might say "I liked the company before at higher prices and it just got cheaper, so let's buy more", but one's gut might be screaming "I better get out now before I lose everything!" Not knowing or understanding one's investments will surely exacerbate this panicky feeling, but having such knowledge doesn't guarantee that one can overcome one's alternating emotions of fear and greed.

Despite the foregoing observations about investment behavior, anecdotal evidence generally does appear to support the assertion that there was no widespread panic selling during the market corrections over the past few years. But one should bear in mind that these corrections, while pretty sharp in several cases, were over very quickly (i.e. the emotional pain associated with falling security prices didn't last very long). Here at PDV, we feel that in a more extended bear market (e.g. like the one from 1972-1974 when the market dropped about 40% from peak to trough), many investors' emotional persistence will be sorely tested, ultimately resulting in widespread selling at inopportune prices.

If you find it difficult to accept the concept that nothing much has changed with respect to the likely investor behavior in a protracted bear market, just look at what happened to bond investors during

1994 after the bond market had one of its worst years in recent history. The Federal Reserve repeatedly raised short-term interest rates in 1994 in an attempt to suppress what appeared to be incipient inflationary pressures, resulting in widespread damage to bond prices. Individual bond investors fled the bond markets, in many cases only selling ***after*** most of the damage was already done, and have stayed away by and large for the past three years. Only ***after*** the bond market rally in the past few months, coupled with the recent damage *already* done to the stock market, did individual investors begin returning to bond mutual funds in droves.

Also, look at the behavior of investors in emerging market funds who couldn't get enough of those markets twelve months ago when stock prices were much higher, only to rush for the exits ***after*** those markets imploded. Similarly, investors in comatose gold-related mutual funds have been bailing out, rather than hanging on for the long run. In the meantime, it is interesting (though not surprising) to note that legendary investors like Sir John Templeton and George Soros either have recently begun or are contemplating investing in South Korea of all places.

Sir John Templeton once remarked that the most attractive investment opportunities are often created when some macro-economic or market event has caused panicky investors to unduly and severely depress the price of good companies along with the bad. He coined this investment approach the "principle of maximum pessimism", and likes to scour for investment opportunities in areas where gloom and doom are pervasive. His ***contrarian*** bent therefore leads him to invest in the very areas that the investment herd is abandoning. Through careful security selection (rather than blindly buying into the country as a whole), he believes that it is in fact much *less risky* to buy into *good* companies once the price has come down and the damage already done.

*This is essentially the "buy low, sell high" approach, a principle easily understood, but much harder from an emotional point of view to practice and execute*. This explains why most individual investors and herd-following professional money managers are selling their holdings in Southeast Asia though equity prices have become a lot cheaper.

Warren Buffett, widely considered to be one of the greatest investors of all time, once said successful investing is largely about controlling emotions. What he meant was that those who are able to have the appropriate emotional response to market developments are more likely to succeed (e.g. buy good investments for the long run on short-term weakness). We could not agree with him more. Given the above examples of human behavior, we do not expect U.S. investors to act any differently in a prolonged bear market in the U.S., as such behavior is prompted by emotions that are an integral and immutable part of human nature. ***Those investors, who can "keep their minds" and remain calm while others are panicking and losing theirs, are much more likely to enjoy long-term investment success***.

Copyright © 1998 **PDV *Financial Management***, 10680 West Pico Boulevard, Suite 400, Los Angeles, CA 90064. Phone: (310) 559-0898 / Fax: (310) 202-9170. All rights reserved. The contents of *Observations* have been compiled from data and sources believed to be reliable, but are not guaranteed as to accuracy or completeness. PDV (and its clients, employees and associated individuals) may, at times, have positions in the securities and investments discussed in this newsletter, and may make additional purchases or sales. This publication is intended to be a source of general information regarding the financial markets, and discussion of specific securities is not (and should not be relied upon as) specific investment advice or recommendation for any reader to buy or sell such securities. Readers should consult qualified financial advisors regarding their particular situations prior to taking any specific action.