

# IRRATIONAL FEAR

IF YOU WERE ONE OF THE MANY INVESTORS WHO PULLED YOUR MONEY OUT OF STOCKS IN THE LAST SIX MONTHS, DID YOU DO THE RIGHT THING?

In December 1996, during a speech to the American Enterprise Institute, then-Chairman of the Federal Reserve Alan Greenspan expressed concern about “irrational exuberance” unduly escalating the value of stock prices. Little attention was paid to his observations – the stock market rose another 60 percent over the next three years before the tech bubble burst.

In response to a question concerning the rise in real-estate prices that followed a May 2005 speech, Greenspan said that “at a minimum, there’s a little froth,” inferring that the rapid rise in house values could not continue for long. We all know what happened to the housing market.

In both instances, Greenspan accurately observed that emotions often push asset prices beyond their real value. More recently – July 2008 – we can add the price of a barrel of oil to this list of assets that were mispriced due to irrational exuberance.

Emotions can also play a role in causing asset values to be mispriced on the down side. That is especially true of today’s stock market. As of late May, the Dow Jones Industrial Average (DJIA) was down more than 40 percent since reaching a high of 14,164 in October 2007. Add to that the fact that \$234 billion was pulled from stock mutual funds during the calendar year of 2008, with investors pulling out another \$43 billion in the first quarter of 2009. That is nearly 14 times the amount that was withdrawn

in 2002. In the face of that kind of selling pressure, it is no wonder that stock prices are down.

Was the selling rational? Many would point to the current condition of the economy and conclude that it was justified. However, consider the fact that the economy was still growing at the time the selling began. Gross Domestic Product increased by 0.9 percent in the first quarter of 2008, only to be followed by an increase of 2.8 percent in the second quarter. Personal consumption was also up 1.2 percent in the second quarter, indicating that consumers were still spending.

The biggest economic concern at that time was the rapid rise of oil prices. But, oil prices had already peaked in July and were down 15 percent by September. It would seem that our biggest economic concern was starting to abate.

So, how did we get from there to where we are today? I believe that it was the fear that gripped the country following the bankruptcy of Lehman Brothers and the subsequent debate of the Troubled Asset Relief Program (TARP) that led to the current economic problems and the fall of the stock market. Americans reacted by going into preservation mode as the President of the United States, the Secretary of Treasury and the Chairman of the Federal Reserve went on national television to say that passage of TARP was necessary in order to avoid the collapse of the banking system. The government eventually had to raise the FDIC insurance level

to \$250,000 per account to avoid a run on the banks.

I often start my talks on investing by asking the group to choose between two investment strategies. The first strategy is to buy high and sell low. The second would be to buy low and sell high. How many people do you think choose the first strategy? Not one. I usually get a few chuckles at the thought of choosing to buy high and sell low. However, that is exactly what many people did recently. They are now sitting in cash, watching the market recover and wondering when they should get back in.

Too many people think of stocks as commodities. What makes the price of oil or gold go up and down? Supply and demand. Commodities cannot make themselves more valuable. Stocks represent ownership of a company. Companies can adapt and change to make themselves more valuable.

What makes a company’s stock valuable is its ability to produce profits and the likelihood that it may be able to increase those profits. This method of valuing stocks is referred to as a price-to-earnings ratio, or P/E ratio. We have historically priced stocks at 18 times earnings.

At times, stocks get overvalued. For example, in 1999, the P/E ratio on the Standard & Poor’s 500 (S&P 500) reached 30 times earnings – an apex of irrational prices to the up side, followed by the tech wreck for the next three years until stock prices got back to where they belonged. The consensus estimate for earnings on the

S&P 500 in 2009 is currently \$60 per share. If stocks were trading at their historic average of 18 times earnings, the DJIA would be at 10,200 today.

When the economy started to slow and slip into a recession, companies reacted immediately in order to preserve their profitability. One ploy was to lay off workers. While we aren't happy with the current state of unemployment in the country, layoffs are necessary in order to maintain profitability. In addition to a reduction in workforce, companies also reduce inventory and think of new ways to generate business.

We are all learning to adapt to today's economy and, believe it or not, it's going to be a good lesson for all of us in the long run. America's businesses are already adapting to an economy that will use less credit in the future. And, the American consumer is also adapting to an economy that will use less credit. The good news is that our savings rate is up and we are paying down our debt.

If you want to be a better investor, I'd suggest that you adopt the buy-low-and-sell-high strategy. A falling stock market is the time to buy stocks, not sell them. I'm not saying that our economy does not have problems – it does and it always will. But, companies will adapt and find ways to make money in whatever economy comes our way. History has already taught us that.

If you are investing in stocks, it needs to be with a long-term perspective. You should forget about what happened in the market today, this quarter or even this year. All assets are prone to being mispriced from time to time – everything from stocks to Florida real estate, gold, oil and even tulip bulbs have fallen victim to pricing errors. As an investor, you need to step back and recognize mispricing for what it is: another instance of irrational behavior. ❖



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