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Julius Baer CIO Letter
The greater fool theory of investing

- **No change in any asset class or currencies made. Asset Allocation remains unchanged.**
- **Extensive discussion on reducing equity underweight.**
- **Investors desirous of being engaged with equity markets at these levels should consider long-short vehicles or index call options. Risk management is paramount now.**

‘Mountain of cash’

One of the things we keep hearing about these days from many commentators is the mountain of cash that is sitting on the sidelines, in money market accounts, to be invested in the stock market and that should drive stocks higher. According to an online blog*, similar sentiments were expressed in 1930 too. According to this site, the 28 August issue of the Wall Street Journal carried this quote:

There's a large amount of money on sidelines waiting for investment opportunities; this should be felt in the market when “cheerful sentiment is more firmly intrenched.” Economists point out that banks and insurance companies “never before had so much money lying idle.”

This is amazingly similar to what we hear now. In order to counter this statement or sentiment, I am going to draw upon the wisdom of the late Peter L. Bernstein, who wrote on ‘Flow of funds and flows of expectations’ in the Journal of Portfolio Management in January 1990.

“The use of flow-of-funds analysis for capital market forecasts is simply inappropriate. The process assumes that we can forecast flow of funds. We cannot. [...] expectations will influence buying and selling decisions over and above current demand and supply. And this is precisely why flow-of-funds is a deceptive tool in capital market forecasting.

The entire game in the capital markets is expectations, not physical use of the item being traded [...].

[...] Flows of funds are the dependent variable and prices the independent variable, not the other way around. The single most visible, critical, and undeniable piece of information in the information-hungry capital markets is price.

Indeed, prices in the capital markets can and do move without a single dollar changing hands. Huge value changes take place on a tiny flow of dollars. On October 19, 1987, turnover of less than 1% of all listed shares was sufficient to knock 25% off the market’s appraisal of America’s leading corporations.”

*http://newsfrom1930.blogspot.com

Well, it is the greater fool theory of investing

In other words, the mountain of cash that is supposedly waiting to get into the stock market would do so only if investors expected to generate positive returns on the cash put to work in the stock market. Or, regardless of their underlying belief about the returns that would be generated by moving that cash into the stock market, they should at least believe that there would be other investors willing to follow them so that they could sell their investments to them at a profit. This is also known as 'the greater fool theory of investing'. That is, a bigger fool would come along after me and relieve me of my foolish decision to invest! There are many problems with this approach to investing.

First, we have seen this movie before, as recently as in 2007, and if my memory serves me right, it did not have a happy ending. The problem is that the US unleashed a policy of loose interest rates in response to the collapse of the technology bubble, the 9/11 terrorist attack on US soil and the collapse of Enron and WorldCom. Other countries followed suit. There was a global liquidity glut. It took five years for the boom to meet with its crash. A lot of money was made in the meantime.

So this time around too, policy intervention centred on easy money and expansionary fiscal policy might end on an unhappy note but it could take longer. The truth is no one knows how and when this will end. One has to go by one's judgement on how much of good news is discounted in the price.

Expectations are already quite positive

The other reason to be wary of the hope that the greater fool theory of investing will keep the financial markets buoyant until fundamentals justify the improvement in asset prices is that the expected improvement in fundamentals appears to be well discounted in stock prices. Operating earnings expectations for the S&P 500 are around USD70-75 per share. Even if we accept them as realistic, the S&P 500 is not cheap. At the current index level, this translates into a P/E multiple of close to 15. This is a shade above the long-term average of around 14 but certainly not below it.

The question is whether the expected forecast of operating EPS of around USD70-75 is realistic. At the earnings peak in 2007, operating earnings were above USD80 per share. But that was due to the extraordinary and eventually unsustainable earnings in the financial and energy sectors. To expect earnings to recover to within a whisker of those levels is unrealistic.

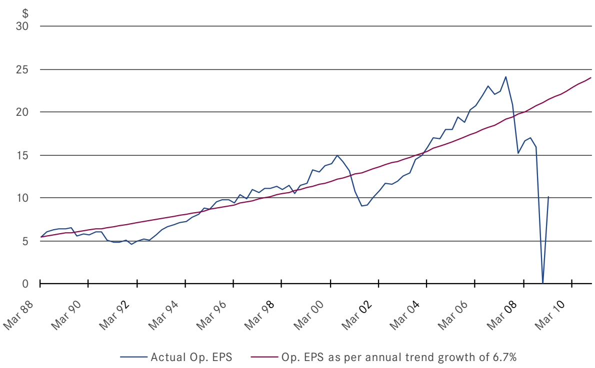
We tried to re-examine the realism of the expectations through another route, not just being content with pointing to the absence of such leverage and aggressive off-balance-sheet tactics by banks.

We evaluated the path of corporate profits as reported by US businesses to the government. The long-term trend growth rate of such corporate profits is around 6.7%. We then extend the S&P 500 operating earnings from 1988 (earliest date from which data on S&P 500 operating earnings is available) with the trend growth rate of 6.7%. Then, we plot the actual realised values of S&P 500 quarterly operating earnings against the trend line (red line chart 1).

What we observe readily from this chart is that deviations from and below the trend take about 2-3 years to correct. The latest deviation from trend has been particularly sharp and deep. Further, it also occurred in the aftermath of the biggest above-trend deviation in 2007 as we noted above. The question is what amount of operating earnings for 2010 would be realistic for S&P 500 stocks. USD15.00 per quarter or USD60.00 per share appears generous. Attaching historical P/E multiples to that earnings forecast gives us a fair value range of 800-900 points for the S&P 500.

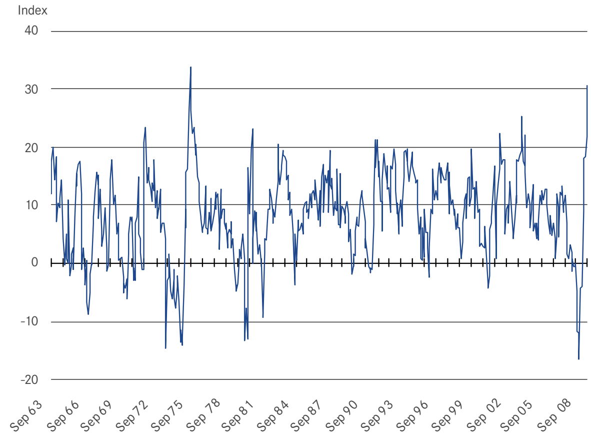
As the index is well above this range, one should not only be underweight equities but should go more underweight if irrational exuberance pushes the index even higher near-term. As the index approaches fair value, one should get neutral on equities, and if the index goes below this range, one should go overweight. This is the risk-management approach to investing, as opposed to momentum-oriented investing.

Chart 1: S&P 500 quarterly operating earnings against trend



Source: Bloomberg, Julius Baer

Chart 2: ISM new orders less inventory



Source: Bloomberg, Julius Baer

Of course, some might wonder whether Asian markets are a better bet. The short answer is NO. Not at current levels. Asia remains dependent on overseas markets for economic and corporate earnings growth. In the short term, the rebound in Asian exports must have largely run its course with the US ISM new orders less inventory at a 32-year high (see chart 2). It is useful to note that sharp, vertical rebounds have been invariably followed by swift and strong reversals.

All of them are beautiful

Sentiment has clearly turned bullish. Evidence from across the world is increasingly positive. For instance in Singapore, residential property prices have climbed back to almost near the peak-2007 levels. Similarly, speculation in commodity currencies has reached the near-frenzy levels that one saw in 2007. The Australian and New Zealand dollars top the list. Investors think that the interest rates available on these two currencies – 3% and 2.5% respectively – are worth fighting for and fighting over. They fail to realise that in crowding into these currencies, they have speculated away future gains and might have stored up future losses.

In fact, this indiscriminate crowding into risky assets happened towards the tail-end of the bull-run that began in October 2002. It is happening now. That should give food for thought.

Concluding remarks

The above framework led me to turn down a proposal from the rest of the Investment Committee members to raise the equity quota in the mandates. That does not mean that equity markets cannot go higher from here. In fact, whether flawed or not, if more people believe in the flow of funds and greater fool theory of investing, they will keep putting more money into the stock market. Those investors who think that this is possible should still keep the risks in mind. Therefore, the better way to participate in further possible appreciation in equities is to consider equity long-short strategies and use call options on stock indices.

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