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Use common sense to balance market's irrational exuberance

Stock Market

Ron Brounes

"Greed is good!" Or so says Gordon Gekko in the movie "Wall Street" and Seth Davis in "Boiler Room." In reality, though, art imitates life. Americans don't have to see these movies to realize that we are living in greed-oriented times. Popular TV shows offer a million dollars to anyone with a decent knowledge of pop culture or insane enough to marry a rich stranger.

However, no where is that greed factor more apparent than in the day-to-day exuberance of the stock markets. Today there is a new paradigm: "buy and hold" has been transformed into "get rich quick." Lots of so-called geniuses have been created in the great bull market.

Their true test will come when faced with some adverse market conditions. (To many, that means anything less than 20 percent returns.)

Federal Re-serve Board Chairman Alan Greenspan's "irrational" comments a few years back were meant to bring the short-term investment mindset down to earth. Instead, the Dow Jones is now several thousand points higher with no end in sight. Today, more investors than ever are able to participate in the rising stock market and are better off because of it. That's the good news. The bad news is, in many cases, investing has become sheer speculation.

CAUSE FOR CONCERN

A CPA friend, who I have considered to be pretty intellectual with a good mind for numbers and a history of common sense, comments she is making a killing these days in the market with the help of an associate of hers (formerly a real estate broker), who has given up his day job to solely track the movements of the stock markets. He subscribes to a number of newsletters written by market gurus (others who quit their non-investment related jobs six months earlier) and is sharing his hot tips with his closest friends.

The CPA has no clue about many of the companies she now owns – not the products sold; not the services offered; not even the industry they are in. Furthermore, she has bought these stocks on margin (borrowed money) in an attempt to hit that home run. While this has allowed her to buy more shares, it also has added considerable risk should her stocks suddenly fall out of favor. No chance of that happening, however. They are, after all, recommended by a real estate broker.

An attorney buddy apparently has made enough money on a few technology issues that he no longer needs to practice law. Today, he shares his wisdom by circulating a newsletter recapping his daily analyses of the markets, the economy and the global trade picture. To my knowledge, he has no formal training in equity analysis other than the countless hours he spends watching a screen and reading such expert sources as (thestreet.com) and the Motley Fool.

I am also the lucky recipient of another market publication that advises the novice investor about trading options, futures and other derivative securities. Having significant academic and professional experience in this area myself, I was curious about the backgrounds of these strategists. They were headhunters (recruiters) just one year ago and have no true experience in the investment industry.

It's interesting to watch Wall Street analysts spread their wealth of knowledge on television. These professionals are typically quite young (often under 30), yet they discuss the markets like seasoned veterans. In most cases, they were not in the business to experience Black Monday (in 1987, many would have been in high school), and have seen few years when the market was not up double digits. To them, any market pullback is short-term and offers tremendous buying opportunities. Often, they disregard "ancient" valuation methods like PE ratios and show little concern when they see companies with no near-term profit expectations trading with billion-dollar market caps. Apparently, as long as a dot-com is attached to the name, the sky is the limit.

GLOOM AND DOOM

I do not begrudge anyone for their investment successes. I too have experienced some good fortune, and, like many, would be susceptible to a down-

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turn in the market. Still, the "market" has become a self-fulfilling prophecy, a trend that may one day be reversed. The Internet has transformed the economy in ways previously unimagined.

We can now communicate and transact business faster, farther and more efficiently than ever before. Productivity is up; inflation is down. Individuals make more money to spend on goods and services (and stocks). Businesses earn greater revenues, and their stock prices rise.

As the markets increase, investors have even more money to spend, and the trend continues – strong economy, high incomes, increased spending, skyrocketing stocks. Because so many tech plays have gone through the roof, impatient investors seek to find that next Dell, AOL or Qualcomm (+2,600 percent in 1999). They make a buck or two on one issue, double up on the next, borrow/margin to invest even more, quit their jobs to trade full time and reap the fortunes of the new economy.

Unfortunately, something may happen to cause the economy to slow: an ill-timed comment by Greenspan or even Abby Joseph Cohen, an unexpected rate increase, additional production cuts by OPEC, another Asian economic crisis, a currency collapse in Latin America, or an act of terrorism abroad. Subsequently, incomes drop; consumer spending subsides. Company revenues (not to mention profits) decline, stock prices fall and investors panic.

'It may not happen tomorrow, next month, or even next year. But inevitably, a correction will occur and may even last longer than a day or two.'

Some may be forced to pay back their margin by selling other securities to raise cash, thus, causing the market to pull back even further. This time, the lower prices may not represent buying opportunities, and investors begin to realize that even advancements in technology do not guarantee profits for all Internet players.

The answer is not to liquidate all positions and hide the proceeds under a mattress. Just be careful and exercise common sense. At the very least, it may be a good idea to understand investments and lighten up on that margin.

It may not happen tomorrow, next month, or even next year. But inevitably, a correction will occur and may even last longer than a day or two. Not all companies will suffer; not all stocks will crater. The Internet economy will still produce many winners, and in the long run, the markets will be far healthier. But when the investor starts taking advice from real estate brokers and headhunters, it may be time to reevaluate. "Greed is good" (to some extent), but even Gekko and Davis suffered in the end. ■

Ron Brounes is president of Brounes & Associates, a business consulting firm serving the financial services industry. This commentary is adapted from a recent issue of his monthly newsletter, "For What It's Worth."