August 2007 Commentary

As investors around the globe try to gauge whether this month's financial-market turmoil is a passing storm or a more-lasting disturbance, we look to two past periods of turbulence for signs of what could come next.

Those two periods -- the stock-market crash of 1987 and the downdraft of 1998 -- bear striking similarities to the present. They also provide insight into the role of the Federal Reserve, which bolstered markets Friday, sparking a rally.

In both 1987 and 1998, stocks fell sharply starting in July or August. In '87, '98 and again this time around, market downturns turned into routs as ***computer-based stock-trading models blew up in the faces of the investors who used them.***

The '87 crash took place in the original buyout boom, which bullish investors foolishly said would keep stock prices high for years. And '98 was the year that a hedge fund called Long-Term Capital Management imploded, forcing the Fed to step in to calm credit markets. This year has been no different. ***We have big buyouts, hedge fund failures and lots of borrowed money.***

In '98, the Fed intervened three times. In '87, the Fed didn't intervene until after the crash, although when it did step in, it succeeded in stopping the bleeding. ***This time, as in '98, the Fed has tried to intervene before things get worse.***

This year, as in '87 and '98, one of the most unsettling aspects of the recent sell-off is that stocks are falling and people don't fully understand why. ***A big reason in each case was the role of computers programmed by people who were supposed to be market geniuses. SUPPOSED MARKET GENIUS NEVER TRUMPS COMMON SENSE.***

This time it was hedge funds using math models, whose forced selling contributed to huge market swings and massive trading volumes over the past few days. The hedge funds, many of whose models were strikingly similar, had to unwind unsuccessful trades involving millions of shares after troubles in the mortgage markets bled into the stock market. The sight of unknown sellers using computers to sell millions of shares of many different stocks, while buying millions of shares of other stocks, promoted panic among other investors.

The models used in 1987 were known as portfolio insurance. The portfolio-insurance models called for investors to protect themselves from losses by making sales in stock-futures markets if their actual stock holdings fell a predetermined amount.

The models were based on detailed analyses of market history, ***but didn't take into account what would happen if everyone using these models all tried to do it at the same time.*** Markets couldn't absorb all the sales demands and the selling pressure helped cause the 1987 crash.

In all three years, ***market turmoil was made worse by overconfident investors using borrowed money.*** The unwinding of all of that borrowing can be brutal because as stock prices fall, investors are forced to sell stocks to pay back their loans, creating a downward spiral. It becomes a self fulfilling prophecy.

The '98 blowup came at multibillion-dollar hedge fund Long-Term Capital Management, which had become the dominant player in the Treasury-bond market. In the summer of '98, LTCM made highly leveraged bets against Treasury bonds and in favor of other bonds, including those of Russia. Its models showed the risk of losing money that way to be minuscule. When Russia nonetheless defaulted on its debt payments, LTCM faced bankruptcy until the Fed helped persuade a group of banks and brokerage firms to rescue it.

For a while, the incident soured many investors on computer models and borrowed money, but with time, new models emerged. The latest vogue was for so-called quantitative, market-neutral hedge funds, which were supposed to avoid market gyrations by betting on gains in one large group of stocks, bonds or currencies, while simultaneously hedging their risks by betting on declines in other large groups. Despite the theory, it has not worked out well.

Another lesson is that the debt markets often pose big threats to stability in the stock market. In 1987, rising interest rates eventually sent stocks plunging. In 1998, it was the risk that the collapse of LTCM could roil the bond markets. Lately, it has been securities backed by high-risk home mortgages. The mortgage securities were so widely held that, when they went bad, they caused credit markets to freeze up, hurting other, higher-grade bonds.

As in 1987, huge investment funds used junk bonds in recent years to take over companies once thought too big to be acquired. In 1987 and again this year, the market suffered once buyouts started to face trouble. Also supporting stocks in 1987 and 2007 was a strong world economy and healthy corporate profits, which investors expected to last for years. Both times, the sudden stock declines shook those hopes.

In all three cases, markets turned increasingly volatile. Sharp drops earlier on proved to be temporary affairs, helping create a false sense of optimism.

There are also some big differences. Stock price valuation looked excessive in 1987, with stocks trading at more than 20 times corporate profits. Price earnings ratios were similarly high in 1998. ***This time around, the ratios remain in the teens, close to the post-1945 average of about 16.***

The real excess now is in lending markets, where investors bid up mortgage-related securities and junk bonds to unheard-of levels, and where brokerages invented bond-like securities. One reassuring difference is that, in the previous crises, problems developed in the Treasury-bond market. ***This time, Treasury bonds remain an island of relative tranquility.***

Another hopeful sign: In '87 and '98, the market's woes were severe but brief. Despite the sharp market drops (more than 36% in 1987, and nearly 20% at one point in 1998), the Dow Jones Industrial Average finished both years with gains. It was up 2.26% in 1987 and 16.1% in 1998, and the S&P 500-stock index was up both years as well.

Besides valuation, Fed intervention and the economy, investors need to watch for other corporate and hedge fund blowups to get an idea of what might lie ahead. The longer it takes to work these problems out, the more likely credit and stock-market problems will be to spill over into overall economy, causing a slowdown, or worse, a recession.

Given all of the above, the bottom line to our clients is that:

1. We are not invested in hedge funds.
2. We are not directly invested in any of the risky mortgage-backed securities.
3. We do not invest with borrowed money.
4. We employ common sense with our investments and do not let computers do our thinking for us.
5. We are long term investors and not day traders.
6. Volatility can be scary over short periods of time, but does not change our long term strategy.

Please call or stop by with questions.

Sincerely yours,

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™