The Future Is Likely to be Tough!

By Henry K. Hebeler
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We've all watched the stock market go down at an amazing rate. So have interest rates. This has all of those in the financial service industry scrambling to get customers to buy something. Without sales, their commissions are zilch. Therefore, you can't go a day without numerous financial institutions telling you that their research says the market will soon head up--so that now is the time to buy. You wouldn't expect anything less. Otherwise, it would be analogous to a car salesman who would tell you to wait until another time to buy any cars on his lot.

The financial industry has a $300 billion dollar annual overhead bill. If there is no income, their employees will be terminated to save costs, and they won't be able to maintain the marble palaces in New York and elsewhere. Financial firms boards of directors will look for new bosses to replace incumbent officers. Fund managers will not get their bonuses. Even more funds than ever will be merged each year to hide the bad performance.

Unless stocks go up, CEOs won't be able to get their mega million compensation packages and will have to rely on indiscernible but lavish perks. The same is true of their boards, auditors, and consultants who are often just one person sharing multiple roles. They emphasize that their company goal is to maximize shareholder value. Translate that to mean maximize the CEO's personal wealth and not necessarily long-term shareholders' benefits. You've got to have your head in the sand to believe that the modern-day CEOs don't know what's happening to their books.

CEO's decisions now are often made on the basis of what will happen to this year's stock price to sweep in the money while it's hot. By contrast, I was fortunate to get exposure to an older generation of CEOs as a relative youngster. When I was fresh out of B school, I listened to our CEO tell his board that he didn't watch the stock price and based his decisions on the long-term benefits to the company. Not watching the stock price was contrary to what I was recently taught by one of the most prestigious universities in the country, so I thought that was a particularly brash statement for our top executive. Not so now. I think that he showed great wisdom. He loved his company and its products. He didn't believe that you could put an accountant with ice-water in his veins in charge of a technical operation. People liked to work there and often remained employed long after normal retirement age.

When will stocks go up again? Not until there is a reasonable valuation. For a number of years now, the price to earnings ratio (PE) of the market has been far above historical averages. In fact, the PE has been higher than in any other time in our history except during the Great Depression when earnings were essentially zero so the PE was extraordinarily high. (Divide any price number by almost zero and you'll get an extremely high number.) Analysts have said we are in a new situation, and history doesn't mean anything. Others try to make the PE more palatable by quoting a lower projected PE based on some optimistic crystal ball estimate of next year's earnings instead of using the past year's actual earnings as has been traditional.

Further the meaning of earnings in annual reports is now corrupted. Companies report "pro forma" earnings. This translates to whatever the executives think the earnings should be if many of the bad things that actually happened were ignored. After all, they reason, that's an event that is behind us and is unlikely to happen again. But in fact these events occur even more frequently.

Acquire another company? We'll "restructure" to make the combination more efficient. Business volume down? "Restructure." Need to improve earnings? "Restructure."

In fact, no one even knows what the real earnings for last year were. Companies use all kinds of definitions. Most try to quote operating earnings that leave out a lot of costs including write-downs, restructuring, extensive option grants, etc. Greedy executives take far more from the companies than they and their next generation of heirs can reasonably spend. Costs are capitalized instead of expensed, things are leased out to another company which simultaneously leases an identical item back to provide the appearance of higher sales and earnings, loans are given to executives and then forgiven, stock options are booked as zero cost outlays, pension fund surpluses are converted to earnings, etc., etc.

Some people estimate that last year's earnings were overstated by at least 20% for the S&P 500 just considering the trick of not costing options. Weyerhaeuser got most of its earnings last year from its pension fund. Global Crossing cooked its books to an incredible degree. Auditors went along with all of this. So did the boards of Enron, Qwest, Tyco, Merck, etc., etc. Merrill Lynch admitted to recommending stocks with known future losses because the investment banking part of the business would fare better.

Let me illustrate how bad the general situation is with contrasting situations. You'll see that the financial industry is really struggling to support its $300 billion overhead.

On the one had, I got a quote from an insurance company for a twenty-year, term-certain immediate annuity. Now this is a very simple investment. There's no estimate of life-expectancy or any other uncertainty involved except what the next twenty years may hold for returns. When I got out my handy financial calculator, I found the payments were based on 3.5% return. The chances are that I'd be better off keeping my money in CDs, government bonds, and/or even money markets for a while.

On the other hand, in the same week I looked at a report of what the major companies in the United States were assuming for returns for their pension funds. This requires that the companies make a similar guess at future rates—not unlike the insurance company. But here's what I found: Twenty-four percent of the companies were using returns over 10% for their estimates. Eighty-seven percent were estimating future fund returns over 9%. (*Pensions & Investments*, July 8, 2002) This corresponds to the long-term historical returns for a portfolio almost entirely in stocks. Now I've got to assume that either these pension fund managers are reckless investors or that they are lying.

It's obvious why the insurance company is selling securities with only a 3.5% twenty-year return. Why then would companies want to show returns almost three times higher? The answer is that they can provide for a smaller pension fund. A smaller fund requirement lets them siphon off funds for other-than-pension-fund uses. And they can call this "earnings." Also a smaller fund requirement is easier to support. The heck with whether its realistic or not. For those with future pensions, this makes the social security shortfall look like a non-problem. This could make the old savings and loan bailout look small as the government steps in to protect part of the pensions.

So far this year, those pension funds must have taken another big hit from the stock market and low interest rates. At the same time, they must mail checks in fixed monthly amounts to those already retired. Thus they must withdraw significant funds in a down market. This is the same kind of reverse-dollar-cost-averaging experienced by a retiree with his/her portfolio. You might say this is different because current employees are making a contribution so there is both in and

out cash flow. But aren't there fewer employees as a consequence of restructuring and the efficiencies of higher productivity?

So what are you to do? I don't have any better insight than anyone else. No one can foresee the future. I think that the portion of my pension guaranteed by the government may be relatively safe, but I'm not as sanguine about the portions of my payments or "guaranteed" income funds that are dependent on a company or insurer's solvency. For my part, I'm looking at the stock portion of my portfolio as something that may still go down appreciably and then recover very slowly. I base my plans on low future returns and other possible market declines. If the market turns out better, I still have my stock funds, and hopefully they'll help me with a more lavish life-style late in retirement.

Meanwhile, I benefit from diversifying my investments years ago and following a strict allocation process. I invest in a number of different types of stock indexes, bonds and real estate. I also make sure that I'm not vulnerable to a major failure in some sector. I keep the total of my stocks and stock funds to a percent between 100 minus my and 110 minus my age. Now, at age 68, my "corridor" for stock allocation is between 32% and 42%.

Actually, I don't believe in buying individual issues of stocks. I'm an index fund person in that regard. But, my wife has lady friends that talk about stocks (when they go up) so she has some too. A couple of years ago we sold my wife's Microsoft and Intel near their peak because our total stock allocation exceeded 110 minus my age. That was pure luck. I only selected those particular securities because I convinced my wife that indexing was better, and those were her biggest individual holdings. But my wife also got lucky because her IRA is entirely in REITs that have turned out superbly.

I'm expecting that the stock portion of our portfolio will be below my allocation corridor soon. Normally, I'd buy more stock index funds at this point, but this time I'm going to wait a while. There's just too much uncertainty for a retiree like myself. In fact, I believe that we may well be living in the disinformation age instead of the information age. It's going to be hard to find an honest price to earnings ratio for a number of years. If I were young, I probably would try to get back into my allocation corridor, but very slowly and cautiously.

But young or old, we all have to be diversified. And we all have to be very skeptical of all of those hungry financial firms who are desperately trying to cover their overhead and hopefully show a profit at our expense.

I have an elderly friend who says that the amount he saves each year is much more important than the return he actually gets. There's a lot of wisdom there if you think about it!