CLIENT **BULLETIN**

MARCH 17, 2004

Christopher Kuehne, MS, CFP
Certified Financial Planner
NAPFA-Registered Financial Advisor
Fee-Only Financial Planning
Investment Management Services

TO All clients of Independent Financial Advisors

FROM: Chris Kuehne

RE: Holding Back on Bullishness

This is another in a series of client bulletins I send to all clients on a periodic basis. I have decided to replace the Newsletter, which I distributed for the last 8 years, with client bulletins. I solicit your feedback on their usefulness; also, if a particular bulletin generates questions or concerns, please let me know.

This bulletin is on the subject of renewed feelings of bullishness, which have been cropping up in the investor community recently, in spite of the terrorism attack in Spain and in spite of high valuations in stocks.

As you may know, the stock market has been rising steadily over the past year; the only hesitation has been in recent weeks with concerns first about high valuations and then the Spain bombings. In view of the sharp rise (the Wilshire Total Stock Market Index of the U.S. up 38.90% and the Dow Jones World Index, excluding the U.S. up 51.96% over the last 12 months), many advisors say their clients have become increasingly bullish, perhaps even excessively so. In January, a net $40.8 billion flowed into stock mutual funds, the third highest monthly total since 1992.

As many of you realize, I (and many other financial advisors) have been urging caution as stocks have become more highly valued. I'm holding cash for many of you, waiting for a period of more reasonable valuations to put your hard-earned money to work.

Renewed enthusiasm for stocks does not surprise Hersh Shefrin, a finance professor at Santa Clara University who specializes in the psychology of investing. He says that many investors suffer from what he calls "recency bias", meaning that their beliefs are dominated by what has happened most recently. So what this means is that some investors who profited from the late 1990s bull market tend to expect such conditions to return. They are therefore looking for evidence that we're heading back in that direction.

Even though many investors expect the market to go back to its peaks of early 2000, that, I'm sure, will prove unrealistic - - the NASDAQ peaked then at 5,048.62 and now it's currently at 1984.73. Even at an absurdly high 20% total return per year, it would take 6 years to get back to the 5,048 level; my estimation is that stocks will return 7.5%, which means a breakeven period of 13 years.

Professor Shefrin calls the expectation of getting back to the peaks of 4 years ago "anchoring to a reference point." Rather than questioning whether stocks were reasonably valued in the year 2000, they imagine instead that the market "is on the end of a bungee cord and will bounce back to its previous high." There is nothing in the theory or practice of finance that supports such a belief.

What seems to be happening is that some investors are becoming overconfident. Investors are used to, as recently as 2000, seeing stocks with high price-to-earnings ratios. But historically, P/Es have stayed below 20; only since the mid-1990s have P/Es higher than 20 become the norm. Prior that that, such levels were very rare.

Another indication of overconfidence (or even irrational exuberance, as Alan Greenspan labeled investors way back in 1997) is that the riskiest stocks have been realizing the highest gains over the past year. Morningstar rates the financial health of 6,000 American companies on a scale of A to F. During 2003, the D-rated and F-rated company stocks had more than double the returns of A-rated ones, on average. This, to me, is a real sign of danger in the markets; such froth cropped up by 2000, and look what happened then.

Please don't think that I'm predicting another huge drop in stock prices. Conditions actually look decent now, in terms of earnings growth, consumer spending and expectations of inflation. Nevertheless, I believe the lesson to be learned here is that a certain amount of contrarian behavior is called for at times like this. One should be seeking out the market niches that have done most poorly, not the ones that have "shot out the lights." Remember, trees don't grow to the sky, so we're probably due for at least a 5% to 10% correction.

Sincerely,
Chris Kuehne