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listeningin

James Montier

London-Based Strategist Offers Reality, And Earnings, Checks. Listen.

The face below may seem familiar. And indeed James Montier's visage has adorned this page before, back in April of 2002. The thing is, James, who handles the equities duties on Albert Edwards' global investment strategy team at Dresdner Kleinwort Wasserstein in London, works like crazy and puts out a ton of thought-provoking reports. He recently put out a couple, on behavioral bias in investing, and the games (still) being played with earnings that are, well, smashing. I couldn't resist giving him a ring. KMW

Clearly, it's the market that has been out-of-step this year, not your forecasts, James—

Absolutely, oh yes. The worst thing that Albert and I have been guilty of over the last six or seven months has been ignoring our own short-term models—even after we had made a concerted effort to create them because we knew we've had a history of not being good at calling bear market rallies. We've been very comfortable with our long-term models and forecasting methods. But we just hadn't come up with a sensible way of thinking about the short term. So last spring I built a couple of shorter term models—asset allocation models and behavior models—designed to capture the way investors actually feel about the market—rather than the way perhaps they should. Based on them, we should have turned bullish in March. But Albert and I, in a mad burst of hubristic overconfidence, ignored our own models. As our quant guys have been reminding us ever since, that is never a good idea. So we are quite rightly chastened for ignoring what we said we'd watch. Hopefully, next time we get it right.

I hear hesitation in your voice—

We're starting to see some of our models show a lot more caution, so we don't feel quite as uncomfortable being negative on the markets right now as we did for the last few months.

Let's talk about the long-term/short-term thing. I hear a lot of moaning about companies' and investors' focus on short-term results—but that's exactly how gobs and gobs of institutional money is being managed. Next quarter is an eternity.

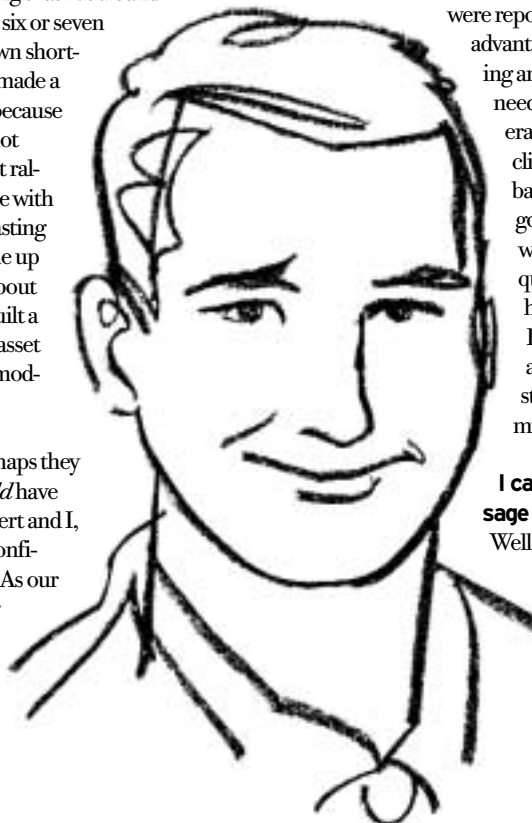
The amazing thing that has become obvious in many of our client meetings over the last couple of months is that institutional horizons have collapsed. If you go back to only 12 months ago, or even six, everyone was talking about the importance of absolute investment returns. They

were repositioning their businesses to take advantage of liability benchmark tracking and attending conferences on the need to focus on absolute return generation. Now, when you go see clients, they've reverted straight back to relative benchmarks. "I've got to meet my target for the next week, the next month, the next quarter." I'm serious, institutional horizons are down to two weeks. But you can't give investment advice on a two-week view. As a strategist, it's not possible. You might as well flip a coin.

I can imagine how well that message is received.

Well, when we tell clients that, the reaction is usually one of admiration for our honesty, if not for our ability!

Has any institutional ever given you a rational justification of that short a time horizon? Most have liability



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Ann Field

Page 1 Illustration

ties that are a lot longer-lived than two weeks.

Clearly. That is the thing that I think is hardest for the institutional managers. So once they see that there is a disconnect between their long-lived liabilities and this focus on short-term performance, they turn around and blame the consultants. I went and spoke to some consultants about this—to see if they were the source of all evil, as it were. I found that while undoubtedly the consultants in the past have played a role in pushing funds into equities, and into fixating on short-term performance, at this point, they've pretty much just become convenient "others" to blame.

They do get blamed a lot.

It's all pass-the-buck games. One or two of them even told me, "Well, now what we're looking for are managers who are prepared to take on *unconstrained mandates*." So they want to give the managers a return target relative to the liabilities the institution needs to meet—and then let them go do it. In other words, it doesn't matter whether the managers want to invest in equities, bonds, commodities, whatever; they just want them to meet a return target.

You actually found real consultants saying that?

Yes, absolutely. And what is more, the consultants now say well, no one seems to want to step up to the plate. It's the fund managers who are shying away from that and holding onto to their familiar existence in their herds—hanging on to their fear of being different, which frankly surprised me.

I don't know. Accepting an unconstrained mandate means accepting that the buck stops here.

That's it, clearly. It's far easier to fail conventionally than to succeed unconventionally. That remains the sad-but-true mantra of the fund management industry, by and large.

It didn't help that not a few putative absolute return managers returned absolutely nothing—or worse.

The hedge fund industry's alarming rate of growth in funds under management—I'm speaking as an outside observer; someone obviously full of green-eyed jealousy that I didn't manage to set up a hedge fund at the right time. But the funds flow into that area suggested—to me, at least—that people were chasing the latest fad in the markets. It is always *stories* that draw in people. It doesn't matter whether they're about hedge funds or internet stocks or structural recovery in Japan, *stories* are very appealing to the human mind. It is only when we begin to focus on the *facts* that we're able to step back and apply a logical framework.

You published an entire report a few weeks back, didn't you, on understanding—and avoiding—behavioral biases in investing?

Yes, I quite enjoyed that, it drew on some of the behavioral research I've been playing around with on the "Visceral/X-System." I was trying to give

investors a heads up. I have a bias. I am massively oriented toward value investing. Part of the reason for that is that I think growth investing is just too damn dangerous. People keep believing the stories. It's always tempting, because their stories make you feel good. They're warm, fuzzy and they draw you in. They *seem* believable. But it's like just investing in the best company in the world—without thinking about valuation. Even though we *know*, at the end of the day, that it is *valuation* that determines long-run returns.

So you cited psychological research that essentially shows people are wired to make emotional investment decisions; that our brains are structured to rely on gut instinct instead of reason when under pressure?

What modern psychologists call the X System, is a way of thinking that focuses on emotion and loves stories. The other way of thinking embedded in our minds, which they call the C System, is far more "Vulcan," preferring facts over fantasy. But the X System is the default option—and the one most likely to be called into action when we are faced with the kind of decisions involved in investing. And yes, the X System is what's more commonly referred to as gut instinct. Trouble is—while there is evidence

that suggests gut feelings can be very useful (For example, grand masters are exceptionally good at playing blitz chess, even at only six seconds per move, because they can recognize patterns without having to *think* about them. The emotional side of their minds can deal with that sort of complex information)—unfortunately, the rest of us aren't grand masters. When we're put under blitz chess conditions, we collapse into gibbering heaps of jelly. The decisions we make as a result are usually sub-optimal, to say the least.

And the market is blitz chess for most of us?

There are a lot of similarities. According to psychologist **Gary Klein**, who wrote *Sources of Power*, in 1999, there are five factors that determine when you are likely to use that emotional side of your thinking. They are almost perfectly characteristic of the decisions we make in financial markets: when the problem is ill-structured and complex; when information is incomplete, ambiguous and changing; when goals are ill-defined, shifting or competing; when stress is high, either because of time constraints or high stakes, and when decisions involve multiple participants. Now, pretty much every major decision I've had to make—and certainly every investment decision—falls into one or more of those categories. I know that I am more likely to be dragged around by my emotional way of thinking than by logical thinking.

So blame evolution for ill-preparing us for financial market survival?

It's been said that our brains are shaped for fitness. That is the way they work. They evolved to keep us alive and to further our species; they're certainly not structured optimally to make investment decisions.

"The consultants now say well, no one seems to want to step up to the plate. It's the fund managers who are shying away from ...being different."

Presumably you read all that psychological research to come up with ways to trick the rational side of your brain into vetting investments—

The prime way of forcing the logical side of the mind to deal with the situation is to focus on the facts. The facts are low in emotional content, so the emotional side of the brain doesn't get excited about them. That means the logical side of the mind can come forward, assess the situation and analyze it properly. By contrast, stories are usually quite heavy in emotion, affective, optimistic, and as such are latched onto by the emotional side of the brain. So the best way of beating the X System is to concentrate on the facts—which means using quant screens because quant screens don't lie.

I don't know. Garbage in, garbage out.

With that caveat, absolutely. Providing you're looking at the right things, they shouldn't lie.

That's a pretty dismal prospect—precisely because sheer numbers—except for geeks—are so devoid of color and nuance.

Exactly why quantitative analysis is so powerful. *If you use it.* The problem, as Albert and I have found, is that when you create models, you are then meant to follow—not ignore—them.

The question is, how closely? Your long-term structural models are quite bearish, so when do you pay attention to shorter term stuff?

Right now is a classic example of that dilemma. The the long-term valuation of the U.S. equity markets suggests that returns are going to be very disappointing. You just can't escape from that. When the U.S. market is as overvalued as it is now, just on a simple reported trailing P/E basis, the median real return over the next 10 years is just 0.1%. Effectively nothing. Buying into the equity market at this level generates zero long-term return.

Based on what model?

What I've done is look at historical P/Es, from 1926 on, broken down into quartiles. When P/Es are in the highest quartile, you're pretty much guaranteed low returns. But that is a million miles from what investors are thinking now. They are trying to reinflate the bubble, relive the dream of 1999-2000.

Not to mention, recoup their losses.

Yes. Loss aversion is a very powerful factor in markets. People *hate* admitting they made losses and the fact they're sitting on them now, or have been sitting on them, has been very painful. So any opportunity to drive stocks higher and get out close to where they got in is going to be seized upon. That is exactly what has been happening. We are seeing a typical bubble echo. We know from all previous experiences with bubbles, no matter what the asset, that it is *not* the bubble leaders that lead you out of the post-bubble environment. In Japan, the bubble winners were the banks, the retailers and the consumer stocks. The big story was all about Japan moving from a production-based economy to a consumption-based economy. In the true post-bubble environment in Japan, the best-performing stocks have been the autos and the electricals—the old production firms. That's because they were 1) beneficiaries of the weak yen and 2) capital-starved during the bubble. They were lean and mean and ready to go in a post-bubble world. Currently, in the U.S., the groups leading the equities markets up are internet stocks, biotech stocks and cyclicals. Cyclicals, at least, I can understand. I don't think they're priced appropriately, but I can understand them. The other stuff is a triumph of hope over reality. The worst example is actually in a European context, because European investors are looking at the U.S. and seeing a cyclical recovery, seeing tech do well, and just following the lazy logic of read-across straight into European markets. They're saying, "Look what's happening in the U.S., now we're going to replicate it here," without any regard to European fundamentals. Right now European tech stocks are actually *more* expensive than they were at the peak of the bubble. That makes *no* sense to me, absolutely none, yet investors have been quite willing to buy.

Isn't this "bubble echo" rally in the U.S. a lot like what happened in Japan after their crash? And wasn't it also led by old bubble stocks?

Yes. It was led by all the stuff that got pumped up during the bubble. It was another example of investors' unwillingness to give up; to take losses. And it was only *after* that first post-bubble rally faded in Japan that people slowly began to realize that they *should* have become disillusioned. This is all about, to me, the psychological path to revulsion.

Revulsion?

The final stage of the Kindleberger bubble process. I just can't see a way of avoiding it. It ends with people embarrassed to admit they own equities; when the *Wall Street Journal* and the *Financial Times* are three pages long. When I've become a bond strategist. *That's* when we're in revulsion. We're still a million miles away. The cult of the equities still booms as never before.

Considering the bubble's unprecedented duration and size, it's not surprising that it looks likely to take a long time to get to revulsion.

No. It's not an overnight process. It could easily be a Japan in the sense of 10 years of market stagnation with immense volatility. That is one reason our TAA model has become so important. If we are entering a period of protracted market volatility, TAA becomes a much more important investment tool.

TAA is your shorthand for tactical asset allocation?

Yes, sorry. During the buy and hold years of the bubble, by contrast, the index was king. It was a disgrace to admit that you were even vaguely interested in TAA. But a prolonged 10-year span, say, in which markets are volatile but effectively go nowhere is the perfect environment for tactical asset allocation. That is one of the points I took out of your interview with **Peter Bernstein** [*w@w 2/28/03*] the need to move away from policy benchmarks for that reason, amongst others.

The environment has changed, change with it.

You're not going to make money by allocating 70%-80% of your funds to equities anymore. We could face a period like '64 to '82, when the Dow went totally sideways for 17 years. Of course, there were tremendous opportunities to get in and out of various stocks and the markets over that time, but buy and hold got you nowhere.

Aren't clients getting pretty tired of hearing your bear case, especially amid this rally?

You can imagine how popular we are. Surprise! Then again, there's a degree of self-selection among our clients. We are known as a bearish house, so the clients who opt to see us tend, by and large, to be rather bearish. People don't like listening to views that disagree with theirs.

You've noticed?

Yes, but it's taken a long time to sink in. The amazing thing now is, even bearish clients are invested and feeling pretty confident that they can properly time their exit from markets. I've been in Europe a lot lately marketing and I've come back pretty terrified. Client after client was talking about earnings momentum as if it was some sort of Holy Grail. All you have to do is watch earnings momentum—upgrade/downgrade ratios, those kinds of things. I've looked at the U.S. upgrade/downgrades ratio, and for sure, it has exploded. [See chart.] To a certain extent that reflects analysts chasing prices as much as prices chasing analysts. (Call me skeptical if you will, but a brief stint as a head of research did nothing to lessen my skepticism where analysts are concerned! I was also very bad at that job, it should be noted. I'm not good with prima donnas, being far too much of one myself, I suspect.

That sounds all too familiar.

Anyway, the earnings momentum series is almost reaching record highs. We are pretty much seeing the same level of upgrades relative to estimate

talkback

Don Weeden & The Market

I read your newsletters and find them very informative and interesting. In particular, I want to thank you for last issue's interview with Don Weeden. At various times I have taught about how the equity markets operate, and I have followed developments in the equity markets for many more years. I think that Don has been at the forefront of some really important innovations in the equity trading.

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High On Don

The interview with Don Weeden is yet another high point in the many wonderful ones I have enjoyed over the past few years. My personal favorite remains the eponymous Kate Welling interview in which you shared many thoughts all of which resonated with this reader.

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KMW Note: See News Bite for the details of John Reed's wholly inadequate proposal to restructure the NYSE.

changes that we saw at the peak of the bubble. When that series starts to turn down, as it *must* do at some point, it won't be pretty. But sooner or later the economic cycle will fade or the analysts simply will have gotten *so* enthusiastic that there is no more upside. (Granted, that's a pretty impossible thing to imagine but now and again they do get the odd reality check.)

Aren't all these upgrades, an artifact of how absurdly beaten down analysts got last year?

Sure. Everyone used to tell me that analysts weren't subject to behavioral biases. That it was all about incentive contracts, they were *paid to be bullish*. But it's now become perfectly obvious that analysts actually are totally subject to behavioral biases. We're seeing exactly the same behavior as when they were incentivized to go out and win corporate finance deals, even though they no longer have that excuse.

So analysts are congenital optimists.

Trouble is, when the various earnings momentum indicators begin to top out, an enormous number of investors will head for the exit at the same time. That worries me. We know that when everybody tries to head for the exit, lots of people are going to get squashed at the door. Many investors aren't being realistic about their ability to time markets. I'm hearing lots of people saying, "This thing is going to turn down, maybe in the first quarter of next year. We'll get out then." When I mention that I'm hearing that from *lots* of clients, they say, "Ah yes, but we *actually* will get out." This massive degree of overconfidence is *so* reminiscent of the bubble. And overconfidence combined with over-optimism is very potent. It leads to expected returns being ratcheted up and expected risks being ratcheted down. So you end up in a bubble echo.

Then with mayhem, at the exits.

Exactly. It's just not an attractive proposition, far too risky. Yet look at the [nearby] chart of VIX (the old VIX, which is now VXO). It's trading at 17%, incredibly low. It reached that level in mid-'98 but prior to that we've got to go back to the mid-'90s to see implied option volatility that low. Right now, put protection is incredibly cheap. I just don't see the point in running naked long exposure to the markets, *after* such a run, when I can buy cheap put protection. But I've yet to meet any investors willing to follow that advice. They're massively confident they can perfectly time the top.

Are those shorter-term models you should have paid attention to in the spring issuing any warnings yet?

The formal tactical asset allocation model that we use is a combination of valuation and momentum. It relates to academic research on identifying market climates done by someone I know you know, John Hussman. Our model is very similar, trying to identify what the risk/return trade off actually looks like in various market environments. It is still saying that momentum is positive and shouldn't be fought. But we run a check on that by looking at a behavioral valuation model which—and I know this sounds nuts—relates the forward P/E to the bond yield and to long-term earnings growth numbers from analysts.

You're right. Why go through *that* exercise?

Because during the bubble years, a number of our clients used to say that is how we should value equities. Now, we *know* that's not how we *should* value equities, but if people are thinking like that, then it's worth modeling. So we played around with a little regression to come up with a way of looking at that relationship. Right now that "myopic model" [see chart] tells us that equities are what could be perceived as 14% overvalued. That's the level of overvaluation the market hit in April of last year, but not as extreme as it got at the peak of the bubble, when this measure got up to 21%. So we're not a million miles away from the point at which lots of equity investors feel they really can't ignore bond markets for much longer—unless analysts upgrade their long-term earnings growth numbers. Which, as of yet, we're not seeing. As optimistic as analysts are, that optimism seems to be limited to the short-term.

Which leaves you, where?

With our irrational models are getting towards the riskier end of the spectrum. There is no longer a clear argument from the behavioral models saying to buy equities, and when I combine that with the complacency I see in the options markets and with the way market leadership is being supplied by the old bubble winners, I am quite certain this is a bubble echo. It's a bigger challenge to work out when it will peak.

Mike Belkin, for one, says the party is about to end. His timing, at least until he got cautious about a month ago when the monetary aggregates slammed into reverse, has been amazing.

The liquidity arguments are slightly strange. I've never found it terribly difficult to work out that monetary growth is going to slow when the banks have dump bonds. And we saw them start dumping bonds six months ago when they got caught off guard by the Fed suddenly backing away from Plan B.

Maybe you should explain what "Plan B" means.

Plan B is Albert's shorthand for unconventional policy measures by the Fed. Effective monetization, be that buying bonds outright, writing options, pegging yields. The electronic printing press speeches and dear old **Vince Reinhart** coming out and backing it up with all the gory technical detail. We can't help thinking that what happened was that the speeches were made *and then* the Fed staffers looked at what it meant and found that unconventional policy actually is quite difficult to manage. In extremis, you have to, if you're buying bonds, be prepared to buy *all* the bonds in existence. That really throws a spanner in the works of the Fed's model. Their models are all based on interest rates and suddenly switching to quantities rather than prices could have pretty dramatic impact. It's okay to buy the odd-billion bonds here, but how about the odd-trillion bonds? It becomes a pretty unknown quantity. Central bankers are a notoriously conservative bunch. We can't see them hopping and skipping down the road of unconventional policy without something *really* nasty. What we have now is almost like a sweet spot for them. Growth is back, everyone is excited about the recovery. Confusing cycle and trend is back in fashion once more. The Fed must be thinking, "Phew, got away with it." But what happens if the cycle fails again?

After that fat GDP number that was just reported?

That's how skeptical I am! There are still massive structural imbalances for the economy to deal with. You will get cyclical pops, just as you've seen in Japan—there were times in the last decade when Japan, believe it or not, was the fastest growing economy in the OECD.

Sure, until its policy makers did something stupid again.

They never cease to amaze me with the sheer number of innovative ways they find to completely screw up their economy. My problem with Japan is that I simply have been burnt too many times before. I've always fallen for the story on Japan, rather than focusing on the facts. I've thought, "This time is different." I've gotten in, been bullish and then forgotten to sell. I won the "Bon Jovi Keep the Faith Award" for my bullish calls on the Japanese market all the way down from 14,000 to 11, then 10, then 9. All because I forgot to look at the facts. Yes, things are structured differently in Japan, corporate balance sheets are in better shape. But there is still a massive burden of debt. So Japanese firms are cash flow generative, but the cash is going to reduce the debt. Until it comes towards equities investors, I can't get that excited about it, as an equity strategist. When I see so many stories about structural reform in Japan, I just get nervous. It is too reminiscent of everything I've seen before and of stuff I've written before. So I was fortunate to cut Japan down to underweight just in time to miss that rather nasty 5% decline. But I'd rather be lucky than right.

Where do investment prospects look brighter?

In terms of equity markets, I'm running what looks like a very odd barbell strategy based on value. I've got a slug of the U.K., which is essentially the cheapest of the major markets, and a slug of emerging markets as natural beneficiaries of a weak dollar policy. Places like Hong Kong and Singapore, to some extent, are actually at incredibly low valuation levels, trading at 15 times 10-year moving average earnings, at a Graham & Dodd P/E. Now, when I first got excited about Hong Kong, it was at 10 times. But it could easily double from these levels and still not stretch the valuation.

But if you're right about the U.S. markets and the dollar, emerging markets won't have much chance, will they?

In many ways my position in emerging markets is a cyclical hedge, they are cheap cyclical to me. I did some work looking at whether cheap countries actually outperform, to check my case rather than just asserting it, as I am prone to do. The good news is that when I tested it, it worked. It didn't matter whether I used P/E's, dividend yields, price-to-book. Basically, the six cheapest countries in the MSCI World Index outperformed the six most expensive by 7% per annum over the period 1997-2003. So there is some protection in the cheapness of emerging markets, while I agree they are not necessarily immune from developments in the U.S.

And when are you betting this year's bull romp will be exposed as the ultimate in sucker rallies?

If I had to put money on it, I would probably go for the tail end of this year, just because the bears are getting sucked in now. When I see them get sucked in, that is the last man off the sidelines. Which to me indicates that things could get perhaps a little more sticky from here on in, but I'll just have to pay attention to my models to see whether I'm right or not. It's tempting to make a sell call here, but I can't help think that it might be just a fraction too early.

What are your sell recommendations?

Japan, obviously. The U.S. I have as a modest underweight. My big sell is Europe, because that looks to me to be an accident waiting to happen. The ECB has been standing there doing a classic, "Oh, we like the strong euro, it's a vindication of our economic policies over the last two years." Forgetting that slowly but surely the euro's appreciation will strip mine earnings from European corporations. It's sad, but the big

Analysts As Bullish As At 2002 Peak



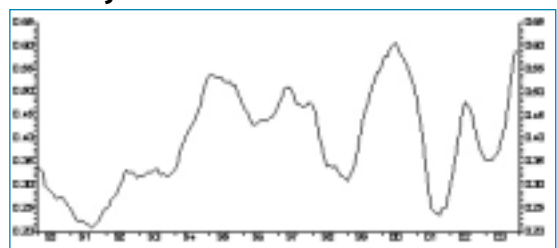
Complacency Reigns, Big Time



Pro Forma Game Playing Continues...



All Hail Big Mo



Charts Courtesy DrKW Macro Research

risk is that the ECB's indifference to the exchange rate sacrifices European growth on the altar of its insanity.

You're sure the U.S. market is priced beyond perfection?

Exactly like we saw in Japan in its first post-bubble recovery. Everybody thinks it's back to bubble rates of growth. Then, when the cycle stalls out, they look like Wyle E. Coyote running into thin air. Then you get the next leg down. Investors in the U.S. are confusing a very strong cyclical upswing—and let's not forget the *incredible* stimulus that has been thrown at the U.S. economy. Let's be honest, if the U.S. economy did *not* react to the sheer volume of fiscal and monetary stimulus it has seen over the last two years, you would have to bury it. Forget the life support, pronounce it dead and bury it. It's absolutely unthinkable that you could throw that much stimulus at a system, and get no response. So it's unsurprising to see a pulse, if you like, but that doesn't mean the patient is recovered. When the stimulus is taken away, the economy will fade again under the weight of the structural imbalances. Which will probably scare the living daylights out of everybody again, and could even drag the Fed kicking and screaming to unconventional policy

Montier on M Scores

"Beneish (1999)¹ provides a simple way of using accounting information to uncover if a firm might be an earnings manipulator...We have often used Altman's Z scores to monitor firms' balance sheets. The Beneish M score is designed along similar lines although it is optimised to predict possible earnings manipulation rather than bankruptcy'. In order to estimate the model, Beneish used all companies in the Compustat database between 1982-1992. Beneish notes 'manipulators typically overstated earnings by recording fictitious, unearned, or uncertain revenues, recording fictitious inventory, or improperly capitalizing costs.' In order to identify such manipulations, Beneish suggested calculating the M score based on a combination of the following eight different indices:

DSRI - *days' sales in receivables index* (measured as the ratio of days' sales in receivables in year t to year t-1). A large increase in days' sales receivables could be indicative of revenue inflation.

GMI - *gross margin index* (measured as ratio of gross margin in year t-1 to the gross margin in year t). Gross margin has deteriorated when this index is above 1. A firm with poorer prospects is more likely to manipulate earnings.

AOI - *asset quality index* (asset quality is measured as the ratio of noncurrent assets other than property, plant and equipment (PPE) to total assets), the AOI is the ratio of asset quality in year t to asset quality in year t-1.

SGI - *sales growth index* (ratio of sales in year t to sales in year t-1). Sales growth is not itself a measure of manipulation.

However, growth companies are likely to find themselves under pressure to manipulate in order to keep up appearances.

DEPI - *depreciation index* (measured as the ratio of the rate of depreciation in year t-1 to corresponding rate in year t). A DEPI > 1 indicates that assets are being depreciated at a slower rate. This suggests that the firm might be revising useful asset life assumptions upwards, or adopted a new method that is income friendly.

SGAI - *sales, general and administrative expenses index* (ratio of SGA expenses in year t relative to year t-1).

LVGI - *leverage index* (the ratio of total debt to total assets in year t relative to year t-1). An LVGI > 1 indicates an increase in leverage.

TATA - *total accruals to total assets* (total accruals calculated as the change in working capital accounts other than cash less depreciation).

These eight variables are combined according to the following formula:

$$M = -4.84 + 0.92 \cdot DSRI + 0.528 \cdot GMI + 0.404 \cdot AOI + 0.892 \cdot SGI + 0.115 \cdot DEPI - 172 \cdot SGA + 4.679 \cdot TATA - 0.327 \cdot LVGI$$

A score greater than -2.22 indicates a *strong likelihood* of a firm being a manipulator.

The model identifies some 76% of manipulators in out of samples tests, while only incorrectly identify 17.5% of nonmanipulators as manipulators. Given the damage done by the revelation of earnings manipulation this trade off between correct calls and false positives looks pretty acceptable to us.

Although only a single example, students using the M score correctly identified Enron as an earnings manipulator, while trained and experienced financial analysts bought the stories offered up by the company."

¹ Messod D. Beneish (1999) The detection of earnings manipulation, Financial Analysts Journal
² Technically the two methods are very different. The Altman Z score was created using discriminant analysis, the Beneish M score is derived from a probit model.

when they suddenly realize the output gap is still alive and well and deflation is still a significant risk.

Or is it inflation that's the real risk, given all that stimulus? Look at the commodities markets—

The commodities markets *are* interesting. But to my mind, what all that soaring open interest in commodities shows is that people think inflation is back in the system and are betting on it. I agree with commodities speculators in one sense. The end-game is higher inflation; the natural outcome. In other words, the only *politically acceptable* outcome in an economy populated by debtors is inflation, because it erodes the debt. That's one of the bigger problems for Japan. They are a nation of *savers*, so the concept of inflation is never going to be terribly politically acceptable. But in the U.S. context, the end-game *has* to be inflation. Now whether the Fed can engineer inflation is another matter. The only time we've seen monetary creation lead to inflation and economic recovery was in the '30s. But that was after 5 years of total depression,

at which point there was enormous pent-up demand. This time, we've got a U.S. consumer who is still doing remarkably well, they're out there cheerleading the economy on. How many more new cars per household can the average U.S. consumer actually buy? Nevertheless they're out there buying. That to me suggests there is no pent-up demand—and that could create a severe break in the transmission mechanism from monetary creation to inflation. You could end up with a situation like Japan, where you have monetary creation and a collapsing velocity of circulation. So all you end up with is more and more money going slower and slower through the system without actually influencing the rate of inflation at all. That is one of the longer term issues the Fed will have to address. Maybe buying or threatening to buy every bond in existence will be enough to get people to say, "They actually *might* create inflation." At which point, yes, go forth and spend. In fact, go forth and buy equities. But I can't help but think it will be from much lower levels than current ones.

So you're worried about both deflation and inflation?

I think deflation is the trigger for that inflation. The output gap remains, even with the degree of upswing that we've had. The output gap is a *levels* concept, not a *growth rate* concept. At best when you get growth at trend, all you're doing is stabilizing output. You need above-trend growth to close the output gap. So far, arguably, we've had that for one or two quarters, but I don't see it lasting. So the output gap will remain a severe drag on inflation, pulling us toward deflation. The policy response will be what eventually gener-

ates a return to the good old days when equities go up because they're an inflation hedge.

The good old days? I remember those days; they didn't feel very good.

That's how depressing I think the future will be, that we'll *think* of them in that way. I've depressed myself now.

So how can you be hard on investors who prefer to fantasize about pro forma earnings?

The whole return to pro forma, made-up, mythical, la-la land numbers, is extremely depressing to me, too. Maybe I'm missing something, but as an investor, the only thing that

matters to me is dividends. I recognize that's an extreme and very unfashionable stance, so I'll talk about earnings. But I'm still only interested in earnings that are available to pay me, which is net income. Yet in the current earning season, in Q3, there is a 22% difference between GAAP net income and the

numbers that the companies report and the analysts use, the pro forma numbers. [See chart.] Everyone is going back to the collective accounting suspension of disbelief. "We don't mind, we're going to focus on 'earnings' that don't belong to us, we'll ignore one-off costs that happen year after year."

One-off, my fanny.

It's absolute crap. When companies start *forecasting* their one-off costs, you *know* they quite clearly are not one-off. Yet that's what we see. The whole rollcall of exceptionals and goodwill write downs and God knows what else are just mythical number creations. They're meaningless and yet everybody focuses on them. I've had some training in psychology and I know people are very bad at learning. Yet I can't help optimistically thinking that people will on average *learn* from their mistakes. The evidence says that simply is not true. People don't learn from their mistakes, either because they don't admit them or because they just *won't* admit them. They prefer to go back to bad habits they learned during the bubble. Psychologists call it "magical thinking." The desire to believe. The faith in equities, the cult of equities is everywhere.

Even scandals aren't much impeding the flow. into funds.

The amazing thing, the very latest numbers I saw still showed still \$17 billion going mostly into domestic funds where market timing is not the issue it is with international funds. The enthusiasm for equities is clearly back, when you go out and talk to people. Yet insiders are selling. The guys who *know* the corporate outlook, the guys who actually put

"We ran the M score on the S&P 500, ex-financials, using the last full reported accounts (2002). Out of the 330 firms for which we have sufficient data to calculate M scores, no less than 57 had a score greater than -2.22, implying a reasonably high probability of earnings manipulation. That is to say, some 17% of our sample are potentially conducting earnings manipulation."

together the earnings guidance, are selling you any amount of equity you'd like, in any size you'd like. Whether from their own direct holdings, or via new issuance or seasoned equity offerings, they are shipping equity out. Personally, I'd rather bet with them than I would with individual investors.

Could earnings unreality be a factor? You recently wrote up a provocative measure of earnings quality I hadn't seen before—something you called an “M Score”–

It's somewhat analogous to the **Altman Z Score** that I've written about frequently, that quantitative screen designed to flag bankruptcy risks. The **M Score** was put together by **Messod D. Beneish**, an accounting academic who wrote about it in the *Financial Analysts Journal* in 1999. It was designed to look for where we might find examples of earnings manipulation—it sent my compliance department into apoplectic fits when I said I was presenting a list of stocks with low M Scores.

I'm just imagining what mine will do–

I like winding them up; keeping them busy. It's the Keynesian full-employment bit of me, it makes me feel better about life. The M Score is a way of looking for potential earnings manipulation. It examines eight different measures [see box] where you might see accounting manipulation, days sales of receivables, asset quality, changes in depreciation and so forth.

The indicators it uses strike me as things any careful bottoms-up analyst would typically look at when tearing apart a balance sheet and income statement.

I totally agree. This is a computational way of analyzing a company. If I were a fundamental, bottom-up investor, I think I'd compute a few of these ratios just to find out what's going on. Realistically, we know that a lot of analysts are far better at preparing income statements than at analyzing them. Which is why I think things like M Scores are actually useful. They provide us with a hard framework for actually exploring these issues.

And when you did that?

When I ran these M Scores on most of the non-financial companies in the S&P500 (there were actually 330 S&P firms in the Compustat data base with sufficient 2002 data on which to calculate the M Score, in part, because it won't work for financials) there were no fewer than 57 out of those 330 that had M scores suggesting a strong likelihood that something was awry with earnings. That represents 17% of the sample. These calculations are based on GAAP numbers, so the implication is that these guys are potentially manipulating earnings *within the GAAP framework*. I'm not even talking about all the pro forma nonsense here. This exercise points to the possibility that the reported bottom lines of 17% of the sample companies are potentially misleading. I'm amazed I haven't caught more flack about this yet. I'm kind of glad, too, because I still have a job.

This may be the last interview either of us do! But your M scores are merely suggestive; They don't prove anything improper is going on. They simply flag instances where various accounting adjustments might be having a larger than ordinary impact on reported earnings.

That's exactly right, I'm not saying these companies are cheating, or doing anything illegal. I'm saying there is something odd in one or more of the ratios that go into their M Scores. So it might be prudent to say, “We shouldn't take these at face value, we need to have a dig around and see what's causing the low M Scores; see if there is a logical reason or if these guys are actually up to no good.”

I presume the professor tested M scores on a larger sample–

He did, he used every firm in the Compustat database between 1982 and 1992; He found their M scores managed to catch 76% of all subsequently revealed manipulators—and only classified 15% incorrectly. Which is pretty good odds, I think, given the sort of damage done recently by revelations of earnings manipulations.

Thanks, James.

Firms In the S&P500 with M Scores >-2.22

Company	Symbol	M score	11/4 Stock Price	P/E
Alberto-Culver	ACV	-2.22	63.96	23.46
Altera Corp	ALTR	-2.08	21.30	57.61
American Greetings Cl A	AM	-1.83	21.91	15.88
AmerisourceBergen	ABC	-1.63	56.40	30.52
Amgen	AMGN	0.25	61.90	38.24
Andrew Corp.	ANDW	-2.04	13.28	103.78
Applied Materials	AMAT	-1.83	24.90	n.a.
Ball Corp	BLL	-1.98	55.86	15.56
Bristol-Myers Squibb	BMY	-1.81	24.89	17.06
Centex Corp.	CTX	-2.05	98.30	8.92
Circuit City Group	CC	-1.98	9.59	n.a.
Concord EFS Inc.	CE	-1.99	10.48	15.27
ConocoPhillips	COP	-0.55	57.02	14.00
Coors (Adolph)	RKY	1.02	55.76	12.91
Corning Inc.	GLW	-1.80	11.67	n.a.
Costco Co.	COST	-2.17	35.29	23.14
Crane Co.	CR	0.12	28.87	87.27
Danaher Corp.	DHR	-2.10	83.33	26.30
Dynegy Inc.	DYN	-0.76	3.99	n.a.
Halliburton Co.	HAL	-1.93	23.89	168.17
Harley-Davidson	HDI	-1.87	48.33	19.80
Hewlett-Packard	HPQ	-1.71	22.98	32.95
International Game Tech.	IGT	-2.04	32.31	32.33
Intuit, Inc.	INTU	-1.86	49.68	40.50
Kohl's Corp.	KSS	-2.12	54.41	30.36
LSI Logic	LSI	-2.12	9.48	n.a.
Lilly (Eli) & Co.	LLY	-1.72	65.25	28.29
Limited Brands, Inc.	LTD	-1.21	17.51	16.40
MeadWestvaco Corp.	MWV	-1.65	25.97	n.a.
Microsoft Corp.	MSFT	-1.65	26.07	28.76
NVIDIA Corp.	NVDA	-2.07	18.07	72.76
New York Times Cl. A	NYT	-1.99	47.74	24.44
Newmont Mining Corp.	NEM	-1.51	43.31	41.54
Northrop Grumman Corp.	NOC	-2.20	88.73	18.11
Occidental Petroleum	OXY	-1.92	35.49	8.87
PMC-Sierra	PMCS	-2.02	20.19	n.a.
Pall Corp.	PLL	-2.18	23.94	28.13
Paychex Inc.	PAYX	6.27	38.78	49.39
PeopleSoft Inc.	PSFT	-2.12	21.36	52.92
QLogic Corp.	QLGC	-2.18	57.04	43.55
QUALCOMM Inc.	QCOM	-1.87	47.32	52.24
Raytheon Co. (New)	RTN	-2.17	26.85	23.09
Rowan Cos.	RDC	-1.82	23.35	n.a.
Sanmina-SCI Corp.	SANM	0.00	10.80	n.a.
Sara Lee Corp.	SLE	-2.01	19.60	14.15
Sears. Roebuck & Co.	S	-1.79	52.75	10.89
Staples Inc.	SPLS	-1.83	26.94	31.44
Sunoco, Inc.	SUN	-2.18	44.20	10.00
Symantec Corp.	SYMC	-1.81	68.15	39.25
Target Corp.	TGT	-1.97	39.44	21.75
Tiffany & Co.	TIF	-2.20	47.53	34.81
Univision Communications	UVN	-1.94	33.63	78.77
WellPoint Health Networks	WLP	-1.84	88.59	15.88
Wrigley (Wm) Jr.	WWY	-2.11	55.79	28.70
Yahoo Inc.	YHOO	-2.17	43.43	130.09
Zimmer Holdings	ZMH	-2.00	64.83	38.81
eBay Inc.	EBAY	-1.96	57.75	92.60

Source: Compustat, DrKW macro research

tradingideas

Too Many Bucks?

Doug Noland is one smart cookie. One smart *bearish* cookie. He writes *The Credit Bubble Bulletin* on the Prudent Bear website [www.prudentbear.com] and handles sundry other gloom and doom chores for Dave Tice's research and fund management empire down in Texas. Even so, he's a nice person.

Also quite naturally inclined to call 'em as he sees 'em. Even when he sees errors being committed by investors of the ursine variety. So it wasn't all that surprising then, to hear Doug state flatly the other day that "the bears are absolutely wrong about there not being enough liquidity. I think the only reason that money supply hasn't been growing is that the GSE's balance sheets have been the monetary growth vehicle instead of bank balance sheets."

Then I could almost feel Doug shrug over the phone, "nobody really wants to believe my analysis..." [In a nutshell, as detailed by Doug in an interview in this publication back in December 1999, it is that massive and destabilizing amounts of credit-money-have been created in the system not just via the traditional bank multiplier but through an explosion of lending and derivatives issuance largely through GSEs] "...but the thing is, in the bear community, we can't say there's a liquidity problem because everything we look at, besides the Ms, says there is *excess* liquidity. Look at all the credit spreads, which have just collapsed. There's money around for *any* company that wants to borrow, *any country* that wants to borrow. There's money everywhere. So trying to say that there's a liquidity issue today is a real stretch.

Then explain the shrinking Ms, I challenged.

"Well, imagine you have money in a retail money fund but you're not satisfied with the interest rate, so you decide to buy a higher yielding bond. You take your money out of the money fund and buy Fannie Mae debt. M2 goes down because your money fund deposit was an M2 component and you no longer own that money fund, you own Fannie Mae debt, instead. But nothing has really changed other than that the monetary liability that we call money supply has dropped. Why? Because your old money fund had been keeping your money in short-term Fannie paper, which it redeemed to pay back to you—and you promptly recycled that sum into long-term Fannie paper. So basically, Fannie just reclassified its own debt from short-term to long-term.

"A lot of where these flows go just depends on the type of borrowing that the GSEs do. Back in 1998, they were aggressively ballooning their short-term borrowings. So we had that huge surge in money fund assets. By contrast, while ballooning their balance sheets in this current environment, they want to raise longer-term liabilities. There's so much liquidity in the bond market, they might as well.

"In fact," Doug went on, "two things have happened in the last few months to an extent far in excess of anything we've ever seen before. The GSE balance sheets—mostly their mortgage portfolios—grew by \$160 billion or so over 3 months. At the same time, we have seen the Asian central banks' balance

sheets also ballooning. The Bank of Japan alone, I think, reported \$65 billion of reserve operations in just two months. To me, those two things entirely explain how we can have so much liquidity sloshing around in the markets. They explain why the emerging markets spreads have collapsed, and why all the credit spreads have collapsed. We have never seen liquidity creation like this. And it's incredibly ironic to me that we have this at a time when it *looks*, to conventional monetary analysts, like the aggregates have turned down, creating a looming liquidity issue."

As Doug sees it [also ECB economist Otmar Issing, see Trading Ideas, on website], the global financial system is still trying to deal with currency and trade imbalances that go back at least to the mid-1980s, but have only grown massively larger in the interim, as one currency and asset class after another has been ballooned to inflate our way out of imbalances. "But we're running out of things to balloon," warns Doug.

Hot emerging markets, commodities and gold spell nothing but trouble to Doug. "Before, even though our current account deficit was growing, money would recycle right back to king dollar, because everyone wanted to play the U.S. dollar, the U.S. economy and U.S. markets. So we got complacent about being able to recycle these deficits. But now, not only is the current account deficit huge, we also have speculative flows *out* of the dollar into these other assets. And that all of a sudden turns what was a manageable problem into one that really isn't. That doesn't mean this can't keep going on for a little while, but with all the excess credit here, where will all the buyers we need to sop up those dollars come from, once these Asian central banks finally say "no mas," or even just slow their buying?

"Think of it, the BOJ is buying dollars in monstrous quantities—and they're just managing to keep the decline in the greenback orderly. That's incredibly ominous. Because keeping the market orderly is crucial for enabling the derivatives players to do what they need to do. If they can't sell and establish their dynamic hedges, then the whole thing breaks down—and right now the BOJ's purchases are providing the buy side of the trade for the derivative players.

"If the derivative players get stuck, that's when you can have a panic crash, Doug speculates. "The troubles we have had, in Southeast Asia, Russia, Argentina and elsewhere, came at the point where they could find no buyers on whom to lay off their dynamic hedges. That's when you get a derivatives meltdown and a collapse. In my mind, we're heading toward testing this scenario here in the dollar. Eventually the central bankers *have* to slow their buying. And when the dollar accelerates to the downside, that's when the derivative players will have to go out and really sell to hedge, which could create your cascading fall. It could be a fascinating test of the whole notion of dynamic hedging in derivatives."

Or proof that they are, in Buffett's words, financial weapons of mass destruction.

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