It's Our Money

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It’s Our Money

We were all once innocent babes in our parents’ arms. They did their damnedest to teach us right from wrong. We were encouraged to tell the truth, the whole truth and nothing but. We were scolded for telling little white lies; punished for telling big fat ones! Nevertheless, they stood by us through thick and thin.

When we first went off to school, the class sizes were small and our friends were many. As time passed, the number of classmates grew larger and the count of close friends became fewer. By the time we got to university, we thought we knew our way around, when in fact we really did not!

Many of us were somewhat lost souls when we first arrived on campus, striving to make our mark and earn a reputation for doing things right. A number of us joined fraternities as a way of gaining an identity. Some got involved in sports and a variety of other activities; few shuttered themselves in the library and spent every waking hour studying. All the while, we tried to keep up with the leaders, be they athletes, playwrights, actors, debaters or whatever. No matter what, we were all expected to get a summer job and pay our own way.

Upon graduation, those who had top tier marks were inevitably offered a number of jobs, some that caught one’s fancy, many that did not. I chose to do something that no one else in the family had ever done before. I joined Union Carbide Canada Limited as a technical sales representative marketing petrochemicals.

After nearly a year of training, I was given a company car, an expense account and a list of corporate customers to call on. I thought I had died and gone to heaven. Little did I know that the competitors’ products were just about as good as ours, the prices more or less the same and their delivery schedules as tight or tighter than whatever we could promise. Life on the road was not as much fun as I had been led to believe. While personality and salesmanship did help, I was hard-pressed to offer any real advantages and thereby easily gain the upper hand.

Fortunately, my primary competitor’s top salesman decided to change jobs and the next guy was not all he was cracked up to be. In addition to which, I came up with a few new ideas of my own and the company gained market share as never before. However, when I asked to be promoted to the position of sales manager, I was summarily told I was too young to take on added responsibility. I quit the company that very same day and went looking for a greener pasture to play in.

Stockbroking had always piqued my interest. When a fraternity brother phoned looking to hire someone to open a Toronto office for an old-line Montreal firm, I jumped at the opportunity. The partners at C. J. Hodgson Inc. could teach me the ropes of investment research and portfolio management. I would help to get the salesforce up to full speed.

Little did I appreciate how the Bay Street crowd, along with the auditors, the legal advisors, and the CEOs of TSX-listed companies would knowingly tinker with, tweak and twist the truth to their advantage and not that of the long-term investor. It has been a focus and concern of mine for nigh on forty years. It has only recently been front-page news across North America and about the globe.

YOU AND I OWN ALL THE MONEY IN THE WORLD

If one is ever to understand how the world turns, it is critical to realize and respect the fact that you and I, collectively, own all the money in the world. Whether we decide to hide our stake under the mattress, deposit it in a bank or savings institution, invest in the stock or bond market directly or through intermediaries like mutual, pension and insurance funds, it is our money. Similarly, federal, provincial and municipal governments can only get by if we pay cash taxes. Money does not grow on trees, and senior bureaucrats and politicians who try to beat the system by printing more of it only end up debasing the value of a country's currency. That is to no one's advantage.

If CEOs, the hired hands, the chosen advisors, the stock exchanges, and the securities commissions were ever to come to this simple conclusion, they might want to mend their ways. At the moment, most seem oblivious to their failings. Witness the detestable practices of the recent past: overstated revenues and understated expenses; excessive compensation packages in spite of less-than-adequate returns on capital; the massive fees paid to investment bankers and the dismal record of research analyst recommendations; and the churning of mutual funds to the advantage of a few large traders and the management companies at the expense of tens of millions of small investors. When you couple this unsavoury behaviour with the fact few of the perpetrators will ever be given much more than a slap on the wrist, it is little wonder why so many hard-working individuals are fed up with the system.

What is surprising is the all-too-apparent lack of leadership when it comes to correcting the sins of the past and being truly innovative and constructive about the future. As I see it, apart from blindly layering on expensive, after-the-fact red tape in an attempt to protect their way of doing things, the various securities commissions in Canada are more or less standing pat. So too are the stock exchanges, the investment dealers, the auditors, the lawyers and the money managers, to say nothing of how sheepish even honest CEOs and corporate directors have turned out to be. Far from standing tall and taking the blame for the error of their ways, few of the culprits seem willing to even commit to being more earnest and effective in the future.

WHAT IS THE ANSWER?

I believe there has to be a sea change in the understanding, attitude and behaviour by all who live off the avails of our money. Those who fail to respect our savings and investments should atone for their misguided behaviour, with suspensions, fines and possibly jail terms.

Why should CEOs allow hot IPOs to be systematically underpriced, primarily to gain institutional investor commitment? Why should private placements be done at a substantial discount, favouring the exempt purchaser over the small investor? Why announce a buyback, rather than institute a reasonable dividend policy? Why pay a premium to "diworseify" when much can be done to improve upon what the company does best, and at a very reasonable cost?

Why persist in claiming that the company's stock is undervalued, when such is the case only about 5 percent of the time? CEOs should also accept the fact that premium multiples must be earned. They cannot be finagled. Target prices are set by those poor people who still believe in the tooth fairy.

Why not have every senior executive buy the company stock with their own money and be on the same page as the long-term investors, rather than just get a free ride by way of a rack of stock options? Why allow independent directors to quit in midstream when the going gets tough? Why not have the auditors report directly to the independent directors, on behalf of the shareholders, and not be beholden to the whims of the CEO? Why not insist that there be a complete breakout of all fees paid to outside advisors, as a way of proving to the shareholders that their money is being put to good use? Why get so excited about short-fused institutional investors, who buy to sell? Why not make the same commitment toward attracting longer-term individual investors who buy to own, and tend to do better in the long run than 88 percent of all the so-called professional money managers!

My point is that CEOs need to treat everyone else's money as if it were their own. If they fail to do so, they cannot expect the outside world to give a damn about their own financial well-being!

A first step in the right direction would be for CEOs to shun most of the blather emanating from the oh-so-sure-of-the-deal underwriters and their always-say-buy research analysts who, by the way, seldom if ever have a well-diversified portfolio of stocks, trust units and bonds, because they simply do not believe in putting their own money behind the firm's investment recommendations. Instead, CEOs must heed the actions of the shrewd and savvy longer-term individual investors, as it is they who steadfastly tend to do better than the stock-market benchmarks, not the pampered institutional investors who seldom stay put long enough to receive the annual report or vote the next proxy. It is a matter of treating the shareholders' money with due respect and never having to say sorry for having come up short.

While we all wait for the necessary changes in understanding, attitude and behaviour to come to pass, it behooves investors to keep a very close eye on what the stock, bond and commodity markets may be up to in the foreseeable future. The following benchmarks are worth considering when doing so.

THE ECONOMIC RECOVERY IS UNDERWAY

Battered by the SARS outbreak, the power outage in Ontario, the forest fires in British Columbia and one mad cow, the Canadian economy grew by only 1.7 percent in 2003, half the rate in 2002. All of which evidently justified yet another two, and maybe the final, quarter point drop in the Bank of Canada rate.

Though consumer sentiment has cooled off somewhat in North America, The Institute of Supply Management's most recent survey of U.S. business conditions posted its eighth consecutive monthly improvement. It now sits at the highest level since September 2001, indicating that the recovery is well underway. This should also have a positive impact on the Canadian economy in 2004.

BE WARY OF THE CYCLES

Known as the stock market's earnings yield, the Fed Model, devised by Edward E. Yardeni in 1997, compares the interest rate on U.S. government ten-year treasury notes with the inverse of the prevailing price-to-earnings ratio. The overall market is said to be undervalued when its earnings yield is greater than the treasury note rate.

According to this model, the stock market is significantly undervalued. The S&P 500 price-to-earnings ratio stands at 18.5, based upon estimated operating earnings for 2004. The earnings yield at 5.5 percent is still higher than the current yield of 4.72 percent on the ten-year treasury note.

If this theory held true, earnings growth should be greater when interest rates are low and vise versa. Unfortunately, according to John Y. Campbell and Tuomo Vuolteenho's recently published study "Inflation Illusion and Stock Prices," that has not been the case. Rather, earnings growth has tended to be better during periods of high inflation when business is booming and prices are increasing. Not so when inflation is low, the economy is flat on its back and pricing power is weak.

Put another way, stocks are a good long-term hedge against inflation, as the growth rate of nominal earnings usually rises and falls with inflation. All of which suggests that some stocks may be overvalued at the moment, as compared to valuations in the late 1970s and early 1980s when inflation and interest rates were sky high. However, better than expected productivity and earnings performance may well justify today's bullish investor sentiment.

Cycles are an integral part of nature. The "Kitchin Cycle," which fits well with stock market cycles, was identified by Joseph Kitchin way back in 1923. It suggests that the normal business cycle usually lasts from forty-two to fifty-four months. It can be shorter or longer, depending upon the nature of the fiscal and monetary policies of the day.

During the life of these cycles, bonds, stocks and commodities are supposed to follow recognizable phases.

Phase 1: Early recession. Commodity prices remain robust.

Phase 2: Deepening recession. Bull market for bonds, but slowing. Bear market for stocks, but bottoming. Commodity prices in decline.

Phase 3: Transition to expansion. Bonds in late stage of a bull market. Commodity prices bottom. The beginning of the rebound in stock prices.

Phase 4: Business expansion starting to mature. Bond prices start to fall. Stock prices move higher, as do commodity prices.

Phase 5: Business expansion peaking. Bonds still in bear market. Stock prices topping out, the early beginning of new bear market. Commodities remain in bull market and may go into a blow-off mode.

Phase 6: Business moving into recession. Bonds nearing the end of their bear market. Stocks heading into a bear market and commodity prices topping out.

THE STOCK MARKET MAY BE ON THE CUSP

For the record, bond prices bottomed out in March 2002, and started to rise just as the highest flying stocks peaked. Commodity prices bottomed in October 2001, the stock market in October 2002. Bonds peaked in June 2003, and have been moving more or less sideways in recent months. Meanwhile, the stock market and commodity prices have continued to rise throughout 2003 and the first part of 2004, typical of a Phase 4 period.

Though there is yet no proof that the stock market has entered Phase 5, such will be confirmed when the bear market for bonds resumes, the stock market rolls over and begins to fall, though commodity prices may continue to climb.

In keeping with the "Kitchin Cycle," the current bull phase may last from two to four years, while the next bear market could last from six to twenty-four months. Whether or not today's bull market for stocks continues along its merry way, a number of stocks appear to be somewhat overvalued. Or expressed another way, in some instances current guidance does not justify today's stock prices. Then again, investors may have a better grasp on the earnings potential than the CEO and management. So far in 2004 most of the earnings surprises have been very positive. Furthermore, until the stock market trades below its low in November 2003, one cannot confirm that a topping-out has occurred. Should it do so, the next "Kitchin Cycle" bottom will not occur until sometime in 2005 or 2006, or possibly as late as 2007.

Scaremongering aside, the commodity related sub-sectors for crude oil and natural gas, metals and mining, steel and forest products should continue to do well for at least the next while. Even so, all CEOs would be well-advised to get out and about and make certain that everyone involved in the investor wealth creation process is kept fully up to speed. In so doing, they may be able to justify and even improve upon prevailing stock prices, or at least cushion the blow when Phases 5 and 6 inevitably kick in and all hell breaks lose again.

A pinch of salt thrown over one's left shoulder for a measure of good luck may also work wonders. Particularly for those who resist the call to paydown their debts and raise additional equity at bull market prices, thereby putting their company on a very sound financial footing for the day when long-term capital is once again difficult to come by, and poorer souls have little choice but to put themselves up for sale.

Lest we forget, forced sales in a bear market never command a premium price. It is also terrible for the longer-term reputation of the CEO, and the capitulating management team and advisors. No one of a right mind should ever allow such to come to pass.

IN SUMMARY

It is time for directors, CEOs and senior management members to come clean, do as they are supposed to do, aiming to maximize the total return to investors large and small. If they fail to address their shortcomings effectively, and do not mend their errant ways, they deserve to be tarred and feathered when the next down cycle inevitably takes hold, the stock market tanks, and many go scurrying about looking for cover.

In the meantime, investors must guard against staying too long at the game. If one is beginning to feel a bit concerned about the outlook for the stock market, one should take steps to get rid of underperforming investment positions. If one has nothing but a portfolio of winners, you would still be well-advised to put a little cash aside for a rainy day. After all, it's our money and we must do our level best to protect our nest egg by keeping away from the ever-present vultures and major downturns in the stock market.