

# OUTSIDE THE BELT-STREET

APRIL 2005

## INSIDE THIS ISSUE:

WHY BEST MINDS?	1
CURRENT VIEW OF THE STORM	2
THE EMOTIONAL FACTOR	3
DISTORTIONS	4
TECHNICAL PICUTRES	5
A LESSON FROM HISTORY	6
EDITORIALS	7

## THE STORY BEHIND BEST MINDS, INC.

I am very excited about our new business move that has taken shape over the last 3 months. Actually, the story started over two and a half years ago when I ran across an active money manager who used long **and short** mutual funds. While 17 years of working only with managers with a long bias was the norm in our industry, by July of 2002, I was looking for a solution and some healing from the war zone. I would look at each potential money manager's numbers and ask, "Were you able to make money during the last 3 years? No—not lose less, but actually **make** money in what has been the most severe down market in a generation."

Since almost every member of our industry (the herd) claimed, "there was no way to see the crash ahead of time", as the next 2 years unfolded, I set off on a mission to read and talk with people who "did see it coming." Our industry was convinced the crash was limited to technology and telecommunication companies, who were the "culprits." However, any number of books - from Maggie Maher's book, **Bull: A Short History of the Bull Market**, to Frank Partnoy's, **Infectious Greed**, to Roger Lowenstein's, **When Genius Failed: The Rise and Fall of Long Term Capital**, quickly bring the reader to the fact that this was not a case of a *few* bad apples, but that the *whole* bunch had added significant systemic risk to the entire money game.

So let's run the clock forward to today. Best Minds, Inc. is a Registered Investment Advisory firm that will provide ongoing consulting to retail and institutional investors. The focus will be to seek the best minds in the industry in giving advice and managing money in a **storm**. Yes, I said a storm. While the 80's and 90's certainly had firms that did well (in a bull market), these managers and tools are of no value to us unless they have the ability to profit in a bear market. In the near future, we will all understand why I rebuilt my entire business. When the season changes from summer to winter, we make changes. For example, we wear warmer clothes. If its a mild winter, this can keep us from being uncomfortable. If its 40 degrees below zero, it becomes a matter of life and death. I, and my clients, are prepared for either.

## SPECIAL POINTS OF INTEREST:

- **SPEED** of condo price increases
- **NASDAQ** compared to the S&P 500 Home-builder Stocks
- What does France in the 1720's have to do with the US today?
- **Bull or Bear Cycle.** Whose turn next?

**A CURRENT VIEW OF THE STORM**

Many financial newsletters give us data. The problem is that there is no point of reference to make sense of it. In this section, I will endeavor to give us a historical perspective. Without this, we tend to lull ourselves to sleep under the false notion that current prices do not matter, since we are investing for the long term, or that the recent decline is just a correction in a perpetual bull market.

**A LONG TERM VIEW OF MARKETS**

PE Ratios for the S&P500 at Major Tops & Bottoms						
Year	1929	1937	1946	1973	1987	Current
Top	21	18	22	19	23	20.5
Bottom	8.5	7	6	7	12	???
Dividend	4%	5%	4%	3%	3%	1.7%

How do the P/E ratios and dividend yields of today compare with other major market tops? As of December 31st of 2004 the S&P 500 reports a current P/E ratio of 20.5% and a current dividend yield of 1.65%. Similarly, Benjamin Graham notes in his book, **The Intelligent Investor**, that in June 1949 the S&P 500 traded at a P/E of 6.3 and had a dividend yield of 7%. By March of 1961, the P/E was 22.9 with a dividend yield of 3%. Not surprisingly, the markets did well from 1949 through 1961, and did poorly after that. The point is that markets change. They go from lows to highs and highs to lows. When P/Es are high and yields are low, markets tend to go down, and when P/Es are low and yields are high, markets tend to rise. Look at the current numbers. Do they look more like 1949 or 1961? As well, most of us are unaware of how high dividend yields can go. For a historical perspective, George Shaffer observes, "The bear market lows of 1932, 1938, and 1942 were accompanied by peak yields in the Dow Jones Industrials of 10.38%, 8.07%, and 7.97% [respectively]. In the bull markets which culminated in 1937, 1938, and 1946 the Dow Jones Industrials yielded 3.7%, 3.44%, and 3.23% respectively."

**Sources.**

- <http://www2.standardandpoors.com/spf/xls/index/SP500EPSEST.XLS>
- <http://super95.com/sys-tmpl/value51/>
- <http://www.crestmontresearch.com/pdfs/Stock%20Matrix%20Index%5%2011x17.pdf>
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- [www.dowtheoryletters.com](http://www.dowtheoryletters.com) , E. George Schaffer, writings on June 18,1949

Notice, at market tops P/E (price to earnings) ratios are high and dividend yields are low.



**Benjamin Graham**  
(1894-1976). The Father of Modern Security Analysis

## THE EMOTIONAL FACTOR

"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."

Charles McKay, Extraordinary Popular Delusions and the Madness of Crowds, 1841.

In November I put together a "test" on our emotions. If you have not looked at it, I would encourage you to download the November newsletter from the website and do so. Over the next few months, I will be discussing questions from that test and referring to writings and other sources on the role our emotions play in our investment decisions. Without this understanding, our risk increases exponentially and can bring financial pain to us and those we represent.

4. True of False — Investors feel more confident about the stock market after it has gone up.

Last year I read a great piece written by Robert Prechter, [www.elliottwave.com](http://www.elliottwave.com), on the differences in purchasing habits in economic verses financial assets. While we can certainly see that price increases slow the consumer down when purchasing goods used for consumption, we do not see the same behavior when it comes to investing. Because of a debilitating lack of information, as investors, we make our decisions in conjunction with, or in opposition to, the behavior of others. We consider an investment safer and more desirable **after** it has gone **up**. After a price has gone **down**, we panic and feel the need sell. Normally, learning how investors are hardwired to make mistakes would make for interesting reading. However, when an entire industry or market has climbed to historically unsustainable levels, understanding our emotional responses to investing becomes crucial.

Lest we be tempted to think that investors are more rational about gains and risk after living through 2000-2002, consider the following.

Henry Blodget, famed internet analyst of Merrill Lynch in 1999, gave a price target for Amazon (when it's stock hit \$150) of \$400 over the next 12 months. This forecast for a **year**. Amazon hit the \$400 price target in **three weeks**.

On February 3, 2005 an article appeared in the New York Times that illustrates similar phenomena today. It recounts the story of a young woman who had flown from her home in California to Florida to visit a friend and buy a condo. The next morning she stood in line with 50 other buyers. When the sales agent summoned her, she was given **four minutes** to decide what unit she would buy. She felt very fortunate to snatch up a 2 bedroom unit for \$350,000, since **eight hours** later when she called for her friend, the prices had climbed to \$380,000, a **9% increase**.

Have we really learned from 2000? Evidently not. We not only buy after things go up; we seem to want to buy in quicker, the faster their prices have risen.



**...eight hours later...the price had climbed to \$380,000, a 9% increase.**  
**Condos today, the dot.coms of yesterday.**

**DISTORTIONS – WHAT DID THEY SAY AT THE TOP?**

One of the things that keeps investors from seeing a storm, is that those they look to in the money game give no indication that there even is a storm. Naturally, the investor reasons to himself, “If there were a problem on the horizon, surely \_\_\_\_\_ would let us know.” The quotes below illustrate why every investor should look at any source of guidance and see how that advice paid off at the top of the last bubble. Several of these were people I used to look to for advice up to and during the melt off of 2000.

*Robert Froelich, Chief Investment Strategist, Kemper funds, January 18, 2000, Wall Street Journal—“It’s a new world order. We see people discard all the right companies with all the right people with all the right vision because their stock price is too high – that’s the worst mistake an investor can make.”* <sup>1</sup>

*Jeffrey Applegate, Chief Investment Strategist, Lehman Brothers, April 10, 2000, Business Week— “Is the stock market riskier today than two years ago simply because prices are higher? The answer if no.”* <sup>1</sup>

*William McDonough, President of the Federal Reserve Bank of New York, September 1999—“If you look at the individual stocks... it is very difficult not to reach the conclusion that individual stocks are behaving very rationally.” March 2000—“I am quite sure we don’t have a bubble economy in the United States.”* <sup>2</sup>

*Robert McTeer, Dallas Federal Reserve Bank President, October 1999, when asked to comment on an article in The Economist, about a giant bubble that was about to burst—“To say that they are right means that you know more than all the people who are buying stocks. More than the market....”* <sup>2</sup>

*Alan Greenspan, Chairman of the Federal Reserve Bank, February 2000, Semi-Annual Humphrey Hawkins Report before the Senate Banking Committee— “The best I can say to you is that it is certainly true that we have a new economy. It is different.”* <sup>2</sup>

*Abbey Cohen, Chief US Investment Strategist, December 24, 2000, New York Times—“...the market is undervalued, the S&P on the order of 15% or so,...the valuations are the best we’ve seen in a long time.”* <sup>3</sup>

If you have forgotten some of the losses during 2000-2002, the market capitalization of the entire US Market was at \$14.7 trillion on March 24, 2000. It fell to \$7.3 trillion, or 50.2%, by October 9, 2002. If you will never forget the losses that occurred during that period, then I implore you to heed these words from the website of a Major Wall Street firm today. “Complacency can lead to extinction.”

(In the next issue, those who warned us prior to 2000, and what they are saying now.)

**“To us, the early-1971-market’s disregard of the harrowing experiences of less than a year before, is a disquieting sign. Can such heedlessness go unpunished?”**  
**Benjamin Graham, The Intelligent Investor, 1971**

The 1973-74 Bear market was the worst since the depression.

**Sources**

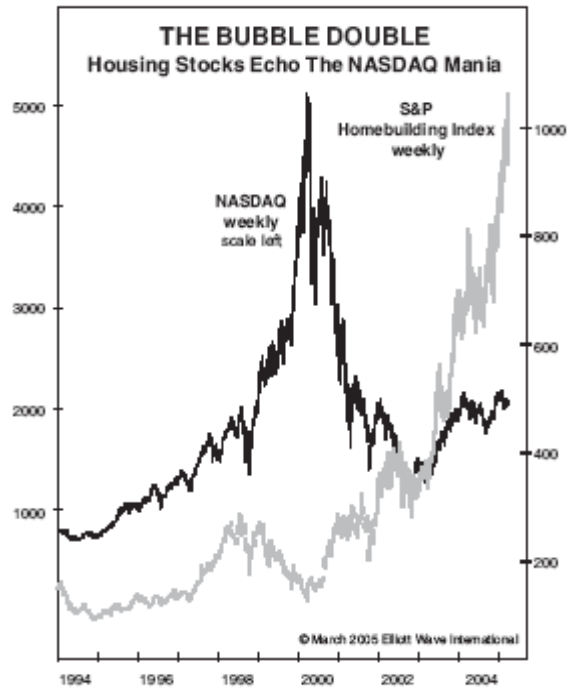
1. **The Intelligent Investor, 4th Edition** (2003) by Benjamin Graham, w/commentary by Jason Zweig. pg 81
2. **Why the Markets Went Crazy,** (2004) Tim Lee, pg 20,21
3. “Whose Investment Prediction Should You Believe?” By John Mauldin, *Thoughts From The Frontline*, 12/27/02

**TECHNICAL PICTURES**

In 2004, I produced a newsletter called Special Edition: Parabolic Rises. If we look at the markets day to day action, we can easily miss these moves. However, if we pull away and start studying patterns from a historic perspective, they become quite clear.

In the chart to our right, produced in March by Elliot Wave International, [www.elliottwave.com](http://www.elliottwave.com), we see how the homebuilder part of the S&P 500 has taken on the same appearance as the NASDAQ in 1999 and 2000.

If we ignore these very clear storm warnings, then we are saying we believe that if one throws a ball hard enough, the ball will continually pick up speed and continually defy gravity.



The sub-prime lenders have broken through the bottom of their trend channel. This points to a probable downward move for other large lending institutions.  
Charts are courtesy of [www.elliottwave.com](http://www.elliottwave.com)



The median sales price on **new** US homes experienced the largest 1 month drop ever, sinking 13% from December 2004 to January 2005. The National Association of Realtors revised the data back to 1988 to include **existing** home sales to make the drop stand out less.

## A LESSON FROM HISTORY

From the charts on page 5, we see a situation that most of us would look at and say, "What insanity!" Even though we may look at the habits of others and come to the quick conclusion that we would never do such things, we must realize that these extreme levels of manic buying are evidence of a more structural problem. This problem is one that has occurred throughout history. In the months ahead, as the storm sets in, it will be imperative, that we ask ourselves, "Have we been here before?" and if yes, "What can we learn from the past?"

In the early 1700's France was in trouble. The extravagance of Louis XIV had severely wounded the credit of France. The national debt was 3,000 million (livres), the revenue was 145 million, and the expenses of the government were 142 million. Since Louis XV was only 7, his uncle, Phillip II, was given the responsibility of finding an astute financier to save France. Phillip's choice was John Law, who purposed to bring France to a paper currency. ***This marked the first time a nation would sanction a paper currency.***

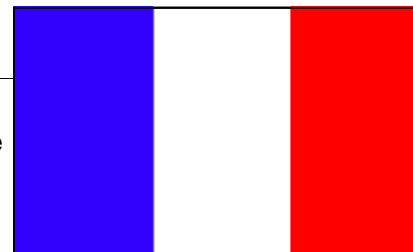
Phase one was the establishment of the Banque Generale, a monopoly bank funded with 6 million livres from the French government. Next, Phillip declared that **all** taxes had to be paid using the new bank notes. In order to give confidence in the new money, Law stated that a banker deserved death if the bank printed more notes than it could back with [gold] coins.

Three years into the process came phase two. Here, Law convinced Phillip to grant him the rights to the Senegal company, the China company, and the French East India company, in order that his new company would have exclusive rights to all trading for the Mississippi River, Louisiana, China, East India, and South America.

Law then offered company stock, bringing quite a bit of excitement. He promised a 200 livre dividend for each 500 shares. The investment was supposed to produce a dividend rate of 120% per annum. At the offering, there were 300,000 applicants for the 50,000 shares offered.

Meanwhile, Phillip noticed that the more notes that went into the hands of the public, the more this solidified their confidence in the new paper money. By 1719, just three years after the Banque Generale had opened, the money supply was 16 times its 1716 amount. In 1719, shares of the new Mississippi company traded at 2830 livres in August, 6463 livres in October, and 7463 livres by November.

This elixir for the French turned to poison in 1720 when the Prince de Conti, took Law to task by asking for a conversion of 100% of his **carriage**, full of notes, to coins. Even though they tried to stop the bank run, it collapsed as investors started demanding gold for their over-inflated bank notes. Have we learned our lesson? As you ponder, consider page one of my May 2004 newsletter.



**By 1719, just three years after the Bank Generale had opened, the money supply was 16 times its 1716 amount.**

## EDITORIALS - ITS GOOD TO ASK QUESTIONS.

Over the course of the next few months I firmly believe we are going to get to a point where all of the pressure that is weighing on this market is finally going to drag it down. As we continue this journey through history, I want to encourage every reader to email me with any question about the “money game” that you would like for me to address. I will then collect various questions as well as ones I see asked elsewhere, and try to answer them in this open editorial format. I hope you will be candid and open. Every investor has questions about money, whether it be theirs or theirs to influence and control. Since bear markets are **not** what most of us are familiar with, then we **all** must be willing to read and then take action on what we learn from history. Procrastination will become increasingly painful and expensive. History teaches this over and over again. It is untenable.

That said, let’s look at a one question that I think most investors should ask today.

**Q— I have all my money in index funds and am not trying to beat the market. Over the long haul I should be fine. Right?**

A— Well, it depends. If we use technical tools like dividend payout, price to earnings ratios, price to book ratios, and Tobin Q, we see historically overvalued markets and a high probability of losing money over the next several years. If we look at many sources of the bull and bear markets of the last 100 years, we see that we are still in the extremes of an overpriced market. We’d do well to regard Jeremy Grantham’s remarks on page 3 of our December newsletter. Reversion to the mean is a constant. No market has ever gone way above its mean without reverting back to it. Never.

Loading up your portfolio with index funds is the optimal strategy for following the herd. While we are told that we cannot beat the market, as it’s going up, buy and hold locks us into the same guaranteed losses as the market goes down. There is no consideration for real world events or prices when using index funds in a buy and hold strategy. **If Templeton and Buffett have made their money by never following the herd, then why should following the herd in mass be considered a safer investment strategy for the long run.** This should be particularly distressing if we are at a market top. Right now, we must ask, “What is my tolerance for loss?” After you have that settled as a percentage, then review history, not theory, by pulling up this chart of historical bull and bear markets from 1901-2004. You may be very surprised at how many **red** boxes you find and how deep the **red** can get. <http://www.crestmontresearch.com/pdfs/Stock%20Secular%20Chart.pdf>



Hey, whose turn is it?

“From 1802-2000 secular bear markets produced an average of .3% return annually, whereas secular bull markets produced an average of 13.2% annually.”

**Stock Cycles,**

Michael Alexander,  
pg.38

Don’t pass over this chart. Take the time to type the address into your browser.

Encourage anyone your know to check out [www.bestmindsinc.com](http://www.bestmindsinc.com)

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## ***The Mission***

When we set out to work on a big project, we always try to get some of the best minds to work with us. With the "Perfect Financial Storm" brewing in front of us, our actions now are more crucial that ever.

Being too busy to learn AND to take action is about to get very costly.

**" THOSE WHO CANNOT REMEMBER THE PAST ARE CONDEMNED TO REPEAT IT. " GEORGE SANTAYANA , 1905**

## **NILES AND "SOPHISTICATED" INVESTING**

My name is Niles Stain. I have been learning a lot about finances in the last few years and wanted to share some of my insights with you . This is the first jewel I have learned. You can get more if you come to my seminar called, "*Borrowing Your Way to Success.*"

- *Debt Is Good-* How else are we ever going to get ahead. My brother, Frasier, purchased a small yacht with zero interest, a lake home with something called an interest only loan, that has great payments, and bought both he and his wife new cars. He's also redecorating his new "getaway" condo, and doesn't have to make payments on the new furniture until 2008, or the new super movie theatre until 2009. Even though the home is near the water, he feels that he needs his privacy, so he put in a pool. The home equity loan was so easy to obtain since his house value has gone up so much in the last 3 months. I've been working on attaining my brother's level of success. Last week, after attending the new "dress for success" seminar, and purchasing my new wardrobe with my no interest credit cards, I knew I had the confidence to attain all my goals. Borrowing your way to success always works.

