LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"Prosperity is a great teacher; adversity a greater."
– English essayist William Hazlitt (1778 – 1830)

As we have discussed from time to time, the stock market goes through long periods of unusually good returns (secular bull markets) followed by long periods of poorer performance (secular bear markets). Three secular bull markets occurred during the last century. The periods were: 1920 – 1929, 1949 – 1968, and 1982 – 2000. (Some debate remains whether the last secular bull market has ended. Increasingly, it appears the stock market made a significant peak in 2000.) Secular bull markets covered about 46 years of the 20th Century. The other 54 years can be characterized as periods of stagnation for the stock market.

The secular bull markets result from an economy which is going through an innovative phase which spurs growth and productivity. During the 1920s the economy was given a boost by the automobile, electricity, and radio. Chemicals, aerospace, and the computer spurred the economy of the 1950s and 1960s while the innovation which propelled the economy of the 1980s and 1990s was information technology.

During secular bull markets, when stocks are rising most of the time, it appears easy to make money in the stock market. As the market climbs, an ever-increasing number of investors join. The longer the cycle lasts, the greater the tendency to ignore risk. Gradually, greed outweighs fear and investors abandon tried and true investment principles, such as diversification and balance. As the secular bull market matures, margin debt rises, IPOs become popular, balance sheets receive less scrutiny, and price-earnings ratios rise. The final stage is marked by a growing belief that this is a new era and that the good times can be perpetuated this time.

Realistically, the good times do not last forever, and the secular bull market is followed by an extended period when the economy and the stock market have to go through a painful wringing-out process. During this period, the stock market seems to be the recipient of a protracted series of bad news as investor focus turns from the positives which were emphasized during the bull phase to the negatives characterizing the bear phase.

The more difficult economic environment that follows the secular bull exposes the excesses that accompanied the good times. The debt accumulated to fuel the expansion during the growth period ultimately becomes a heavy burden. Accounting controversies emerge. Interestingly, controversies and secular bear markets tend to go hand-in-hand. For example, corporate bankruptcies and unraveling frauds were among the hallmarks of the 1930s, following the secular bull market of the 1920s. One accounting trick of that era was to create elaborate webs of holding companies, each helping hide the other's financial weakness, an artifice strangely similar to what Enron did with its partnerships. One of the biggest shocks of the 1930s was the collapse of a vast, high-flying utilities empire called Middle West Utilities run by an energy magnate and financier named Samuel Insull. When overly-leveraged Middle West Utilities entered receivership in 1932, many saw their life savings wiped out.

Accounting scandals also accompanied the bear market following the 1950s and 1960s secular bull. In 1975, The SEC censured Peat, Marwick, and Mitchell, one of the largest accounting firms of the day, for failing to perform proper audits of five companies that collapsed soon after getting clean audit opinions. Today, Enron's collapse has been followed by the downfall of others and renewed suspicion of auditing practices. The situation has deteriorated to where, almost daily, the value of another company is pummeled when questions arise about its accounting for profits or its excessive debt.

With the wind in our face instead of at our back, investing takes on a different perspective. There is renewed appreciation for companies with low equity valuation, strong balance sheets, and a dividend yield. Simple commodity stocks tend to work better than the complicated former glamour stocks. Boring stocks become fashionable, and the new high list consists of names one has not heard about for some time. For investors, the goal shifts to one of protecting capital rather than maximizing wealth.

As investors, we have to adapt to the environment. What worked during the secular bull is unlikely to work during the secular bear. As suggested by William Hazlitt so long ago, how we handle adversity is more important than how we handle prosperity.

March 2002

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