Red Herring, a Fool's Errand, and Trying to Find the Next Winner

A rational person who studies the history of American business cannot help but marvel at how many of the most celebrated firms of one era fail to survive to the next. Even in recession, free-market economies are characterized by intense competition. Often, a company's toughest competitor turns out to be a firm of which it has never heard—selling a product or service it does not know about. The list of companies that once dominated their industries but no longer inhabit the earth is lengthy enough that it should give every trend chaser pause.

Among literally hundreds of examples, a number of firms come to mind that were once highly regarded but later encountered severe or even fatal obstacles.

- One that hits close to home is Bethlehem Steel, which pioneered the steel I-beam and fueled a skyscraper boom across the country. Its engineering expertise supplied the steel sections for the Golden Gate Bridge. However, growing competition, corporate glut, and a changing marketplace eventually took their toll, and the firm filed for bankruptcy in 2001.

- On November 10, 1997, WorldCom and MCI Communications announced their $37 billion merger to form MCI WorldCom, making it the largest merger in U.S. history. On September 15, 1998, the new company, MCI WorldCom, opened for business. On July 21, 2002, amid scandal and lack of competitiveness, WorldCom filed for Chapter 11 bankruptcy protection in the largest such filing in U.S. history at the time. Bondholders ended up being paid only 35.7 cents on the dollar. The stockholders' stock was canceled, making it totally worthless.

- In 1973, Eastman Kodak held a seemingly unconquerable position in the profitable market for photo film and chemicals. Kodak enjoyed a reputation for innovation and boasted a market value even greater than oil giant Exxon. Kodak shareholders had been favored with an uninterrupted stream of dividends dating back to 1902. Today the company is struggling to reinvent itself as the film business shrivels, the dividend has been suspended, and the share price is a shadow of its former self as it limps along under three dollars.

- The final day of operations for Circuit City's brick-and-mortar stores was March 8, 2009. Circuit City closed more retail locations in the U.S. than any other retail chain in 2009. After the final date of operation for all Circuit City stores, the company's online store was replaced with a page that read as follows: Circuit City would like to thank the millions of customers who have shopped with us during the past 60 years. Not surprisingly, no word of thanks or apology was offered to shareholders.

It's fascinating to us that some companies almost single-handedly create new industries but still find it difficult to turn innovation into a permanent advantage. Pan Am (air travel), Kmart (discount retailing), Polaroid (instant photography), and Wang Laboratories (word processing) all had impressive initial success and at one point provided handsome rewards for their investors.

Neither Pan Am nor Polaroid survives today, and Kmart shareholders were wiped out when the firm emerged from bankruptcy in 2003. Kmart, Polaroid, and Wang Laboratories were all cited as examples of "excellent" companies in the 1982 bestseller *In Search of Excellence,* by Robert Waterman and Tom Peters. The U.S. market has returned nearly 10% annually since then, yet shareholders of these "excellent" companies have seen their investment vaporize into thin air.

Not to worry, though; for every story of corporate implosion, we can find another tale of decline followed by dramatic (and always over-sensationalized) recovery. According to some accounts, Apple was only a few months from bankruptcy when Steve Jobs returned to the company in 1997. Now it vies with ExxonMobil for the title of largest company on the planet. And who would have imagined that a floundering New England textile firm

with a low-margin business that sells suit-lining fabric would one day become a financial colossus known as Berkshire Hathaway?

Our point is that neither "experts," nor hedge fund managers, nor the media, nor your loudmouth neighbor can reliably predict which companies will end up like Enron or which companies will ascend as Apple has. The thrill of owning a stock during its most lucrative phase is a nearly narcotic incentive to search for the "Next Big Thing."

Rational investors reject this temptation to speculate because they know the unassailable truth, which is that every company with a highly profitable position is under constant attack from competitors they don't even know are out there. They know that every fallen giant makes room for dozens of new companies to seize market share and make their shareholders wealthy. That's why a properly diversified portfolio includes small-cap and micro-cap stocks.

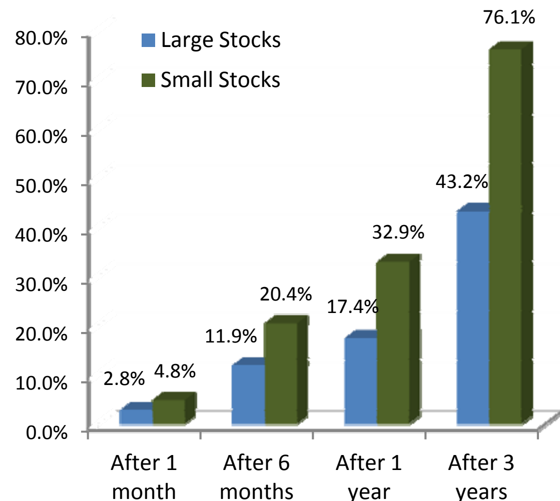
Searching for firms destined to generate beat-the-market profits for many years into the future is fraught with peril, is fraught with hubris, and is likely to end in silent frustration. Our view is that most investors will be far better off harnessing the forces of competitive markets and holding a diversified portfolio of 12,000+ stocks in 45+ countries, not chasing individual stocks.

The Sorrowful Plight of the Retail Investor

It has happened again. It's really hard to stomach if you, like us, harbor compassion for the average investor. Despite a nearly 100% gain in global stocks between March 2009 and July 2011, the average investor has been a net seller of stocks. In fact, retail investors (those buying financial products on their own or being suckered into broker-sold products) have sold $47 billion or more of equities than they have purchased during the time period in question. Perhaps two optimism-sapping bear markets in the last decade, well-publicized examples of corporate malfeasance, and the uninspiring leadership in Washington have made investors forget about the very nature of capital markets. More specifically, that ***stocks tend to go up following recessions.***

The following graph shows U.S. stock market performance for various time periods after a recession. Each recession from 1953 to present is captured in the data.

Stock Performance After Recessions: 1953–2010



It should be noted that small stocks do not outperform large stocks following every recession. We're not advocating abandoning large-cap stocks; we're simply demonstrating that it makes sense to capture the returns from both large- and small-cap stocks following recessions.

It breaks our hearts to see that time and time again retail investors just can't seem to avoid selling stocks after prices have fallen. Sadly, the ill-advised retail investor seems to retain the stubborn habit of taking the risk but bailing out before the return. We want to keep you in a bubble where behavioral mistakes are not made. The plight of the retail investor makes us want to drive down your driveway, standing out of the sunroof with a bullhorn, shouting with amplified fervor, ***"This is a group of knuckleheads that you don't want to join!"***

Perhaps it would be a bit more courteous if we simply continued to enhance our ability to be a steady, rational, guiding hand to help you navigate through the emotions associated with investing in the capital markets en route to your most closely held financial goals.

Sovereign Debt, Downgrades, and Stock Returns

Unless you've been hiding under the proverbial rock, you've surely heard about Standard & Poor's downgrading of U.S. government debt from a top-rated AAA down to AA+. In the weeks preceding the event, there seemed to be an endless cacophony of market observers predicting that a downgrade would result in higher interest rates and lower stock returns.

We don't know how else to hold these prognosticators accountable, other than to point out their folly. And it would be disingenuous to use the benefit of hindsight in this matter, so as is our nature, we will stick to strictly the data.

Regarding bond markets, history offers examples of major developed countries that experienced a credit downgrade without a significant rise in interest rates. Examples include Australia, Canada, and Japan, which lost their top ratings in 1986, 1992, and 1998, respectively. Interestingly, after the downgrade, yields on U.S. government securities fell across the term spectrum as investors around the world rushed to purchase supposedly downgraded U.S. bonds.

Careful research suggests that countries with high credit ratings may withstand a downgrade better than countries with lower ratings. One study looked at sovereign credit rating downgrades since 1990 and found that bond yields changed little among countries downgraded from the highest triple-A rating. However, countries with lower credit ratings (single A or below) experienced significant interest rate increases following their downgrades.

A similarly important question is whether the U.S. downgrade has played a role in the U.S. market downturn.

In the right-hand column is a chart that summarizes stock market performance of respective countries after a rating change. It is based on a study of ratings changes made by Moody's from 1983 to 2009. During the 27-year period, the ratings agency made 71 upgrades and 25 downgrades to governments in the developed and emerging markets tracked by MSCI—so there is plenty of data for a meaningful analysis.

The study identified the date of each change and logged each country's market performance in the 12 months after the event. Each country's market returns were compared to the respective market index and the excess return averaged for all events. (Excess return refers to performance above or below the respective market index, either MSCI EAFE or MSCI Emerging Markets, as appropriate.)

Equity Market Performance After Moody's Ratings Changes: 1983–2009

Sovereign Bond Rating Change	Return in Excess of Market, 12 Months After Rating Change
Upgrade	**3.87%**
Downgrade	**3.73%**

The aggregate results show that cumulative returns in the 12 months following a rating change were almost the same for the upgraded and downgraded countries (3.87% vs. 3.73%). That's scientific erudition for really saying that upgrades and downgrades don't tell us a thing about what will happen with stock prices, so you shouldn't worry about them.

The resultant implication is that market prices reflect all available information and expectations about a country's economic prospects—including the possibility of a rating change. By the time a country's debt rating is upgraded or downgraded, the market has already integrated the news into prices. Stock markets reflected positive economic developments prior to a rating upgrade and negative developments before a rating downgrade.

Perhaps we really did not need an academic study to know that markets work faster and more accurately than ratings agencies to assess a country's financial condition and evaluate the potential impact on its cost of capital and equity market.

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Sources for this quarterly perspective:
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