Was Facebook the Death Knell of Equity Investing?

By Martin Hutchinson *Wed, Jun 13, 2012*

The ever-bearish Martin Hutchinson expects equities to represent a good value again... when Ben Bernanke is gone and after the Dow Jones Industrial Average settles to about 5,000.

The Facebook initial public offering, with its combination of management arrogance, private equity greed and Nasdaq ineptitude, has certainly changed the atmosphere in the U.S. and global stock markets. The question is whether, like the ill-fated AOL-Time Warner merger of 2000, it has merely marked the peak of a temporary bubble or the final end of the equity investing cult among the ordinary public.

In the stable days before 1914, retail investors bought few stocks. Bonds represented the best means of saving for retirement or other purposes. Because Britain and the United States were on the Gold Standard, principal on bonds of first class governments and major railroads and corporations was secure against inflation and the interest suffered either no income tax (in the United States before 1913) or a low rate of income tax (as in Britain from 1842 to 1914). Thus investors in even corporate bonds enjoyed a safe and substantial real return, provided only that the corporation's assets had not been "watered" by issuing more bonds and stock than the properties were worth. (In that case, whether for a railroad or a producer of a commodity such as steel, the costs of servicing the excess debt or equity made the company potentially uncompetitive against a rival railroad/producer whose bonds/stocks had not been "watered.")

In Britain, the lack of equity investment was caused by the mass of government bonds available for investment after the Napoleonic Wars. The merchant banking system did not get around to carrying out share issues until the Guinness share issue by Barings in 1886. Instead it made its money by issuing bonds, diversifying into foreign government bonds initially and then reluctantly into railroad bonds. To get your shares listed, you had to run the gauntlet of a terrifying set of fly-by-night company promoters, of which Anthony Trollope's villain Auguste Melmotte was ethically at the top rather than the bottom end. Middle class investors like John Galsworthy's Forsytes, to the extent they invested in shares at all, invested primarily in the hope of a substantial and improving dividend rather than of capital gain. Mostly they stuck to bonds or, for the more adventurous, rental real estate and mortgages thereon (all those lawyers in the family gave them access to good deals).

In the United States, where the financial markets were even gamier than in Britain, the public invested in bonds, primarily of railroads and state governments, until right at the end of the 19th century, when equity issues sponsored by J.P. Morgan gave adventurous investors some assurance that the company in which they invested was not an outright swindle.

That changed in the twentieth century. First, with inflation, bonds were no longer a solid investment – Soames Forsyte's Uncle Timothy, still in Consols at the age of 101 in 1920, was by then very eccentric and somewhat impoverished. Closed-end mutual funds had existed in the nineteenth century, but the invention of open-ended mutual funds, in the 1920s in the United States (Massachusetts Investors Trust, 1924) and in the more prosperous 1930s in Britain (Municipal and General Securities: First British Fixed Trust, 1931), allowed small investors access to the stock market for the first time. In the United States, the Great Depression knocked the markets back, as did World War II in Britain, but persistent inflation and increasing prosperity in the 1950s brought the cult of the equity to both countries.

In Britain the building societies (which paid interest free of basic rate income tax and whose rates floated with interest rates generally) provided stiff competition to equities until the period of negative real interest rates in the 1970s. In the United States savings banks and from 1974 money market funds also remained in the game. However from 1980 the great bull markets in both countries made the equity markets supreme. In the 2000 presidential election, George W. Bush ran successfully on a program of investing Social Security payments in the stock market, since it was apparently bound to provide much higher returns.

This all changed after 2000, as equity markets worldwide failed to offer reasonable returns. They had been bid up to an inordinate extent in the late 1990s bubble caused by Alan Greenspan's lax post-1995 monetary policies. They were not allowed to fall to a market clearing-level after 2000, as the Fed and other central banks continued to expand money supply excessively. It's now clear that certainly the 2002 stock market bottom and probably the 2009 bottom were false; that is the decline was reversed by artificially pumping money into the system before a true market-clearing bottom had been reached. Calculations based on nominal GDP growth since the February 1995 change in U.S. monetary policy suggest that a middling level, not a bottom, for the Dow Jones index would currently be around 8,200, so that at today's levels the market is still 50% overvalued.

It's not surprising that investors today find equities unattractive; they have been subjected to twelve years of nominal returns close to zero and negative real returns. For a "value" investor it is very difficult to persuade oneself that equities are currently worth buying, other than in the commodities sector where their value rests on the inflated prices of the underlying commodities.

The Fed's post-1995 policy has thus been extremely damaging. First it inflated equity values to a ludicrous extent, far above any possible rational calculation of value. Then, instead of allowing markets to correct to a level that could have represented "good value" and from which savers could have achieved a high return with only modest risk, the Fed kept prices artificially inflated, but subject to large unpredictable downdrafts such as that of 2007-09. For a thoughtful investor, equities in this environment represent a very poor investment, and will only represent a good one when monetary policy has been corrected and market excesses have finally been wrung out. Needless to say, since we only have a finite lifespan, a period of 15 years or more in which common stocks are a poor, overvalued investment has been a major deterrent to using them as the basis for our retirement and savings planning.

Only in emerging markets was the decade of the 2000s lucrative for equity investors, and there for most U.S. investors information was scarce and the barriers to investment high – many of them erected by the Securities and Exchange Commission and Sarbanes-Oxley legislation, making it hugely expensive for foreign companies to list in the United States, and more or less illegal for U.S. brokers to sell to retail investors the shares of foreign companies that were not so listed.

It's thus not at all surprising that investors are disillusioned with equities. The problem is, the alternatives available to them all have major disadvantages.

Private equity may look logically like the alternative to stock market investment. However overvaluations here are even more extreme than in the public equity market. Interest rates are at record lows, artificially reducing the cost of leverage, while corporate earnings are at record highs in terms of GDP. Both factors can be expected to go into reverse in the near future. And private equity bears much of the blame for the Facebook bubble. The plethora of "insiders" investing at a $60 billion valuation in a company whose true value was no more than $10-15 billion (its competitor LinkedIn is valued currently at $10 billion) drove up valuations to an absurd extent, and their attempt to unload their holdings onto "greater fools" in the public market at a $100 billion valuation produced the fiasco we have just witnessed. Compared with public equity, private equity provides no diversification, just an opportunity for money managers to raise their fees to absurd levels without providing significant additional value. And, by definition, private equity investment is more or less unavailable to investors who are not multi-millionaire favorites of the major brokerage houses.

Hedge funds are now consistently underperforming other investments and should be avoided at all costs. They add no economic value and provide vastly excessive profits to their sponsors. Institutions that invest in them are throwing away their pensioners' and policyholders' money; we should avoid joining them.

Debt, whether top-quality or lower quality, is a huge bubble waiting to burst. The fact that Vanguard has closed its "junk bond" fund to new investors is sufficient indication that supply of money here hugely exceeds that of legitimate deals.

Gold, silver and other commodities are less of a bubble, in spite of the huge increases in their prices. The need for consumers in high-population emerging markets to buy products that "hurt when you drop them on your foot" is real, and so therefore is the surge in commodities demand. On the other hand, natural gas has recently shown that supply innovations can bring down commodity prices with a bump, and this is likely to happen elsewhere. The money-supply boost to commodity prices is real too, but will last as long as Ben Bernanke holds his job and not a day longer.

Real estate has cost investors their shirts in the last decade, but is actually now a good investment. Not commercial real estate, whose prices have been inflated by cheap financing, nor residential real estate in Britain, where prices are still far too high, but in the United States, outside the major coastal cities, home prices are now reasonable, in spite of subsidized financing. Rentals will continue to increase compared to sales in the lower/middle-price brackets, so a well-located apartment block in an area of low unemployment is probably one of the better investments available right now. The better-heeled Forsytes took advantage of these opportunities; so should we, provided leverage is kept moderate and holdings conservative.

Equities are never going to regain the place in investors' affections they held in 1995-2000 and nor should they – that was a bubble, too. Nevertheless, with the exception of careful, moderately leveraged investments in residential real estate, there are no other good alternatives. Once Bernanke has gone, and we have suffered through another major bear market taking the Dow Jones Index down to 5,000 or so, we should once again make the public equity markets, with adequate global diversification, a substantial part of our investment strategy.

Martin Hutchinson is the author of Great Conservatives *(Academica Press, 2005). This column appeared on*

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