THE PERFORMANCE ERA

A talk by Bosworth M. Todd, Jr., President of Todd-Boston Company, Inc. to the students in the senior investment course at the University of Kentucky on March 11, 1969.

There have been many changing philosophies as to how to invest over the past twenty years --- a period which began with the widespread distrust of the sustainability of earnings in the post World War II period. But as the economy continued to roll along without serious readjustment, (the much feared post-war depression never came) this cautious attitude gave way to an acceptance of common stocks as reasonable investments which would provide the investor with an average annual gain of 9 or 10%, including income. The performance era, which began in the early sixties, holds that much greater gains can be achieved by aggressive management. I don't know how long this attitude will last or how far it will carry.

Until the performance era, much of the investment thinking was an inheritance of and reaction to the experience of the 1930's. Investment managers sought to avoid risk, avoid volatility, avoid turnover, and, to a greater extent, even to avoid decision making. It was a period that gave more weight to prudence than to performance.

Gradually, starting in the '50's, and picking up steam in the '60's, "performance" took over, and investors increasingly asked "How much money can I make?", rather than, "How can I protect my principal? "

Therefore, the money manager, whether he likes it or not, is being forced into the performance game under threat of loss of business.

A new breed of fund managers and security analysts are taking over a large part of the institutional investment community. They tend to be young, tough, flexible, able, self confident, and ambitious. Many of them are under 30 years old. They are all alert to new ideas and do not have either the advantage or the handicap, as the case may be, of the wisdom and experience of some of their older colleagues. They are extremely optimistic --- they are very competitive. Their reaction time to market-moving news is almost instantaneous. All of this has led to a climate characterized as ranging between unprecedented sophistication to a giant "crap" game. The rapid communications of ideas has led to an almost "herd" instinct among many professionals.

The usual economic analysis has too often been partially replaced by searching for "the right stock to be in". There has been a massive substitution of technical work, such as charts and supply-demand analysis, for the usual fundamental analysis.

The problem is whether the new group of performance investor is operating on intuition, pure "story-buying", whim and impulse, or whether it is exercising mature, carefully thought-out, rational decision making, based on knowledge of the facts and a background of experience.

Professor Colyer Crum of the Harvard Business School said: "Performance investing is good management, knowing what the facts are, mobilizing more data, thinking logically, drawing out all the gossip and old wives tales, or, more succintly, placing increased emphasis on thinking clearly". This type rigorous analysis must be present and replace pure hunch, tips, or other un-informed nonrigorous methods.

Half of all mutual funds in existence were started in the past two years. Over 80% of new fund sales are in the "performance" area. These funds have, in effect, been purchased as stock equivalents rather than a conservative investment medium. Therefore, they are more likely to be redeemed as such in a poor market, thereby raising the specter of mass liquidation of such mutual funds. We have already witnessed this experience of Mates Fund difficulties last December.

While there is some evidence that the performance craze is dying out, it is clear that simply buying blue chips and putting them away, avoiding risks, reaching decisions via committees, diversification, absence of trading and many of the other time tested rules have not provided adequate guidelines for successful investing in recent years.

Those who are likely to succeed in today's changing environment must possess a strong investment philosophy, a logical decision making process. Sustained results cannot be achieved by whim and intuition.

Now let's look at the securities market. Buyers of bonds have shown nothing but losses for 18 years, whereas, buyers of stocks have shown nothing but profits. High grade corporate bonds now yield 7 1/2%, the highest ever. Dividend yields are the lowest in history --- under 3%. Trends of this duration inevitably become such an integral part of conventional wisdom that too few question it's continuation. Inflationary expectations have made bonds unpopular to an extent not seen since the late 20's.

We are having literally two stock markets. Stock prices have risen in the past year in inverse proportion to the degree of quality involved. Thus the Dow Jones Industrials are selling at 16 X estimated 1968 earnings of $57, below the mean multiple of 17.5 X during the past decade. In contrast the A.S.E. index, at 33, is 25 X, up from 18 X a year ago.

The stock market excesses of the past two years have been confined to areas which many investors are not even aware of. The majority of high quality stocks are selling at normal appraisal levels.

Our consulting economist, Pierre Rinfret, feels that most observers have underestimated the magnitude of economic growth likely in 1969. He believes government spending and capital expenditures will be much higher than generally believed. He also believes interest rates might get to 8% before year end. If this is true, it's too early to buy bonds, but these high rates are getting tempting. Furthermore if; 1) the Federal Reserve announced objectives of breaking the back of inflationary expectations are met, or if 2) there is, by some miracle, peace in Vietnam then we can be bullish in the bond market.

The rapid growth in money supply in the past two years has played no small part in enabling the speculative stock boom to continue. This rate of growth is now being slowed, since the Fed. is free from the constraints of having to accomodate the financing of a large Federal deficit in the money market. Thus the current restrictive monetary policy should be considered a distinct negative for stock prices over the next six months --- at least those stocks, such as many A.S.E. and OTC issues, which have skyrocketed in price in the past year or two.