

# The GIRTON CAPITAL GROWTH LETTER

Discovering and Tracking Great Growth Franchises

March 22, 2004

## Behavioral Finance and the Sentimental Market

In the past twenty years a new science called Behavioral Finance has sprung up, making the claim that the behavior of the “rational investor” is, in fact, riddled with irrationality. The budding field is a composite of probability theory, statistics, finance, and psychology. Two defining books on the subject were published at the height of the Internet market mania in 1999, the academic *Beyond Greed and Fear*, by Hersh Shefrin, and a layperson’s book, *Why Smart People Make Big Money Mistakes – and How to Correct Them*, jointly written by Gary Belsky and Thomas Gilovich, former Money Magazine writer and psychologist, respectively.

Following are a number of behaviors from the above books that appear to be irrational and counterproductive, hampering investors in their financial decisions. 1) Mental Accounting – why one dollar that you win in the lotto, or some other windfall, seems worth less to you than one dollar you have saved in your savings account for over a year. 2) Loss aversion: why losses seem to hurt more than gains feel good, and what this means for investment choices, 3) Sunk cost fallacy: why a person believes their original cost basis is relevant to a stock’s current value – also known as “get-evenitis” 4) Decision paralysis: why, when you have owned something for some time, it is harder to be impartial about it than had you never owned it. 5) Small numbers add up – For example, why people don’t pay much attention to inflation of 2 or 3% per year when making long term financial decisions. 6) Anchoring: paying attention to facts or figures that are irrelevant to the subject at hand – for example, if a stock has been at \$40 for some time and suddenly goes to \$30 for a good economic reason, it nonetheless seems cheap at \$30. 7) Overconfidence – why we forget our past financial mistakes, trading costs, or tax effects, but remember our victories. 8) Confirmation bias: Why we are looking to confirm what we already know or believe. 9)

Herd investing or the “information cascade” – why what many others do make it easier for us to make the same mistakes they are making, 10) Gambler’s fallacy – that is, the “hot hand,” or if heads come up five times in a row, do you bet on heads? and 11) too much information: why knowing too much about a company may not help us – in other words, familiarity does not equal knowledge or an “edge.”

Behavioral economists take the above “irrational” behaviors and others, and suggest that the market is “irrational” since many of the people in it are. One major tenet of the financial behaviorists is that investors often overreact or under-react to information, depending on its timing, and that this can be quantified in order to make money. Furthermore, behavioral finance appears to explain “the madness of crowds,” including the European tulip mania and more recently, the Internet Bubble.

However, an article written by options pricing guru Mark Rubinstein appeared in the June 2001 FAJ called *Rational Markets: Yes or No? The Affirmative Case*, subtitled, “Rumors of the demise of the rational market hypothesis at the hands of behavioral finance are greatly exaggerated.” The article was inspired by a debate between Rubinstein and Richard Thaler, one of the deans of Behavioral Finance. Thaler’s book, *The Winner’s Curse*, examines in detail why so many US corporations pay what in retrospect appear to be exorbitant prices for companies, and then rue the day they made the purchase. While Rubinstein concedes that companies “occasionally” overpay for other companies, and adds that “surely the average investor believes he is smarter than the average investor,” (see overconfidence, above) he asserts that “clearly, markets can be rational even if not all investors are actually rational.” He also states that “even if we decide that markets are not rational, they may still fail to supply opportunities for abnormal profits.”

Behavioral Finance may be a way of academically explaining phenomena that are the tools of the “technical analyst” or chartist, who have claimed to understand investor psychology for years, but are generally not academicians. Some of their aphorisms, such as “the trend is your friend,” “climbing a wall of worry,” “breaking support (or) resistance” and tracking such measures as market breadth, the put/call ratio and money flow figures, amount to reading the tea leaves of investor psychology.

Long-term stock investors sense that behavioral finance may really be nothing new, but it does recognize, and characterize (mis)behaviors in a measurable way. While we do not believe Behavioral Finance lays out a new overarching system to make money in the stock market, it does help us *as individuals* to avoid common financial mistakes, and therefore, it should be studied. And although the market may be sentimental, it still is certainly difficult to tell what the crowd is going to do next. Thus, our focus remains on fundamental financial and industry research to discover and invest in leading growth companies.

### **Consumer Confidence vs. Investor Psychology**

The two market statistics nearest to the domain of behavioral finance are consumer confidence and investor sentiment. These statistics are closely related – for example, the economic leading indicators contain both consumer confidence as well as the stock market’s performance. However, consumer confidence doesn’t always show a one-to-one correspondence with investor sentiment. Consumer confidence often arises from a strong jobs report, which, unfortunately, we are not getting right now. Investor confidence seems to be better related to how well stocks have done in the past twelve months. It is useful to keep up with the major measures of confidence and sentiment in the market, so that we can use them to understand what “the herd” is thinking, and try to stay one step ahead.

One of the best known consumer sentiment indexes is published by the University of Michigan. It fell to 94.4 in February from 103.8 in January, and then dropped slightly to 94.1 in March. The March report showed that consumers feel better about the present state of the economy but that they feel worse about their expectations for the future.

Another major measure of consumer sentiment is the Conference Board Consumer Confidence Index. In February, the index fell by 9 points to rest at 87.3, versus 96.4 in January. This index showed that more consumers claimed that jobs are “hard to get” and that less consumers expect conditions to improve in the next six months.

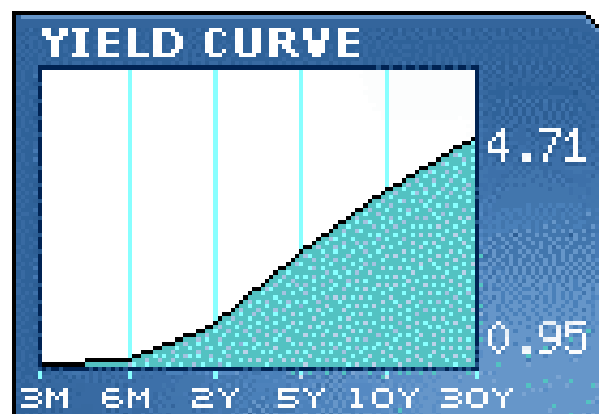
Investor sentiment has been measured by a number of surveys, including the popular American Association of Individual Investors (AAII) sentiment reading and the Investors Intelligence Advisors Sentiment Index, which measures the sentiment of market letter writers. The AAI survey swings around from week to week – recently its bullish ratings fell and its bearish ratings rose, but it is overall still bullish. The Investors Intelligence rating is fairly high right now, at 52.5% bullish advisors and only 21.8% bearish.

A March 2000 Financial Analyst Journal article, “Investor Sentiment and Stock Returns” found that there was a significant inverse relationship between the sentiment of Wall Street strategists and individual investors and future stock returns, and a similar, but less powerful relationship for market letter writers. This lends credence to the idea that when investors are bullish or complacent, as they have been until recently, it makes sense to be cautious.

### **Rates Down, But Inflation Threatens Market**

Low rates along with a steep yield curve are generally very positive for the market, as buyers become more attracted to stocks versus bonds.

#### **US Treasury Yield Curve – Low and Steep**



Interest rates have declined back to very low levels: to the 5% area for 30 year mortgages, versus about 5.5% when we last wrote in December. Also, monetary growth has remained strong year over year at 6.4% for M1 and 4.1% for M2, and has re-accelerated on a three-month basis. The Federal Reserve's March 16<sup>th</sup> statement was almost identical to its January 28<sup>th</sup> statement, except that it reduced its statement on economic expansion from "expanding briskly" to "continuing to expand at a solid pace" and that "although job losses have slowed, new hiring has lagged." This suggests that the Fed continues to be concerned about GDP and employment growth this year. GDP growth declined to 4.1% in the fourth quarter of 2003, versus 8.2% for the third quarter, and moderate growth of 4-4.6% is projected in 2004. The committee continued that "it can be patient in removing its policy accommodation," suggesting that the Fed may not increase the Fed Funds rate until later this year or early 2005.

This is a tricky time for inflation, however, as oil prices and various commodities, such as soybeans, milk, and platinum have been increasing steadily, while others, such as coffee, wheat and orange juice have risen more slowly. Meanwhile, gold prices, after hitting a high of over \$425 per ounce, have backed off somewhat, and the US currency has had a minor rebound, back to \$1.23 per Euro versus recent highs of \$1.27. Arguing for worldwide inflation are countries such as China, where GDP growth is red-hot, as well as India.

The rally in oil prices to \$37-38 per barrel is also a matter of major concern, as this is the highest level seen in years. OPEC's official target range is \$22 to \$28 per barrel, with Saudi Arabia favoring a price of \$25 per barrel. But nations such as Nigeria believe the official target should be increased perhaps to \$30 to \$31 per barrel or more. A lot of people are blaming oil prices on the increased Chinese demand for oil and automobiles. We have to wonder whether it is not more related to OPEC's desire to keep oil prices high. This is certainly creating an opportunity for alternative sources of energy, like the ones found in our "Isn't it Time for Alternative Energy?" piece. It is probably a good time to avoid investing in economic sectors downstream from expensive oil, such as the transports, or chemicals.

## CRB Inflation Index Creeps Up Towards 300



## Market Valuation

Looking ahead to 2004, the bottom-up estimate for the S&P500 (SPX) is \$62.93, and the top down earnings estimate is \$60.80, for an average of **\$61.87**, up 1.06% from last report's \$61.22. For 2003, the preliminary S&P500 earnings figure is **\$54.74**, up from last quarter's composite estimate of \$54.25. The end result is that 2004 corporate earnings projections are 13% higher than 2003.

With the S&P 500 now at **1,095**, the P/E ratio to 2003 operating earnings is **20.0**, and to 2004 is **17.7**. Assigning a P/E of 20 to 2004 earnings of \$61.87 targets the market at **1,237** in the next year or so, an upside of 13% from current levels. However, the stock market is clearly in a correction at the current time, down 5.9% from its recent high of **1,163**, which was a peak P/E of 19 to 2004 estimates, driven mostly by inflation fears, in our opinion.

A classic 15% correction from that high would place the market at **988** for the SPX, which would represent about a 16 P/E to 2004 estimated earnings – while a more modest 10% correction would put the SPX at **1,046**. A correction is substantiated by the movement of the VIX volatility index, which has broken out to around 22, after lying dormant for the last six months. Ahead of and during this correction, we have been buying more conservative stocks, such as Johnson & Johnson and Merck in our last letter, and the stocks mentioned below. We continue holding growth stocks with good stories and balance sheets, and are looking to add new investment positions as opportunities arise.

### **Portfolio Companies Update**

**Portfolio Actions:** Since our last letter, we sold Albertson's, Disney and Long's Drug for certain portfolios. We bought Equity Residential, Krispy Kreme, Palmsource and Tofutti Brands for accounts depending on suitability.

**Affymetrix** (AFFX \$31.72 - Target \$40+) as expected, has introduced a number of new arrays based on its one-chip genomic arrays, including an array for *Drosophila* (the fruit fly used in genetic research), and Zebrafish (used in developmental studies). The company also announced its 7 chip smallpox resequencing array to identify and catalog hundreds of smallpox strains kept by the Centers for Disease Control (CDC). Due to the refinancing of 5% bonds (which we held) by bonds yielding just .75%, and a better than expected fourth quarter, street earnings estimates have been increased to \$.55 per share for 2004 and to \$.88 for 2005.

**Equity Residential** (EQR \$30.00 – Yield 5.7%) is the largest publicly traded apartment company in the United States, with 968 properties in 34 states. Sam Zell is a founder and shareholder. The low end of company's guidance is for \$.50 in Q1 earnings, and \$2.15 for 2004. The company's dividend is \$.4325 per quarter, or \$1.73 per year, which gives it a payout ratio of about 80%.

**Jacada** (JCDA \$3.13 - Target \$6+) reported a disappointing fourth quarter, with revenues down 8% to \$5.1 million. However, the company still has \$42 million in cash and no debt. Jacada is closing its Minneapolis facility and moving it to Israel. More importantly the company is planning to introduce a significant new product in the second quarter to integrate information from Windows and mainframe computers – one potential use is integration of fraud detection information.

**Krispy Kreme** (KKD \$33.27 - Target \$45) is the well-known doughnut company based in Winston-Salem, NC. The stock has backed off from a high of \$49.74 this year due to some slowing in its internal sales growth rate. However, overall earnings growth has proceeded at a good pace, driven by new store openings, with EPS of estimated at \$1.17 this year and \$1.50 in 2005. While the company has mostly completed its US development and is filling in operations here, it still has large potential overseas.

**Palmsource** (PSRC \$16.73 - Target \$30) reported earnings of \$597,000 or \$.06 per share for its February quarter, but guided to a loss in its May quarter. Recent events include an agreement with RIMM to jointly develop a Blackberry connectivity to the Palm OS, and the release of a new operating system called Palm OS Cobalt, which will be used for smartphones and mobile devices. We believe Palmsource's valuation of about \$195 million, 2.8 times its sales of \$70 million, compares favorably versus RIMM, with a \$7.5 billion valuation, or 16 times trailing 12 month revenue of \$471 million.

**Scansoft** (SSFT \$5.51 - Target \$7+) announced that Warburg Pincus would purchase Xerox's 15.9 million shares for \$80 million. The company reported strong fourth quarter revenues of \$46.9 million, up 65% from the year ago number due to the acquisition of Speechworks, and the launch of Omnipage 14, as well as PDF converter. The company guides to \$.20 per share in earnings in 2004, before amortization of intangibles and non-cash stock compensation. We view the company as the leader in speech software, with upside for embedded speech applications in automobiles expected in 2005.

**Tofutti Brands** (TOF \$3.66 - Target \$6+) is a leading provider of soy-based products, including its Tofutti Cuties ice cream substitute bars, soy cheese slices, and Tofutti blintzes. This small company has over \$2 million in cash and no debt, is profitable, and has sales of close to \$20 million, with a market value of \$21 million. The company's largest customer is Trader Joe's. When wholesale prices of Tofutti's components settle down, such as cocoa and soybeans, we expect the company to post earnings growth.

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