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COMMENTARY

Market Opinions And Topics Of Interest
April 5, 2001

The Bear Market
Part 2 – A Look At The Reverse Wealth Effect

"Its point is, essentially, that despite all the carnage last year in the Nasdaq, people haven't sold. In fact, investors continued to pour money into aggressive growth mutual funds throughout last year's selloff at more than twice the rate they had during 1999's blow off." **An Interview with George Noble in welling@weeden, March 2001**

As the quote above suggests, the $64,000 question is whether investors will sell their funds. Chart 1 provides a look at the pain they have endured. To construct this chart, we used Investment Company Institute (ICI) data through February 2001 and The Leuthold Group's estimates for March 2001.

From October, 1990 to March, 2001 investors poured $1.454 trillion of net new cash flow into domestic equity mutual funds. The market value of this new cash at the end of March was $1.847 trillion. This means the market value was $393 billion greater than the cumulative sum of the net new cash flow or, the unrealized profit held in domestic equity mutual funds was $393 billion.

From the peak 16 months ago, investors in mutual funds have seen their unrealized profits fall from $753 billion to $393 billion, a decline of $380 billion or 48%.

Is This Correct?

Many people that have analyzed Chart 1 are surprised by its findings. They believe the losses should be greater.

If one considers this chart in light of the statistics detailed in Part 1, it should not be that surprising. The current bear market has been concentrated primarily in technology and communications. While there has been tremendous pain in this sector, the rest of the market has held up reasonably well. Likewise, the level of unrealized profits has held up in equity mutual funds as well.

Aggressive Growth / Tech Sector Specific Funds

How did technology stocks affect the overall level of unrealized profits in domestic equity mutual funds? Chart 2 attempts to answer this question.

This chart was constructed using weekly data from The Leuthold Group. This data can be found in their weekly *Supply/Demand* flash report. The top panel shows the NASDAQ (our proxy for the performance of Aggressive Growth – Tech Specific Sector funds) and the average cost for investors in these funds since December 31, 1996. The bottom panel shows the cumulative profit/losses of these investors since December 31, 1996.

From December 31, 1996 to March 28, 2001 (latest data), investors in these funds poured $207 billion of net new cash into these funds. On March 28, 2001 the market value of these funds stood at only $105 billion for an unrealized **loss** of $102 billion (or 49% below their average cost).

The results of this poor timing have been a huge swing in the unrealized profits/losses (or loss of wealth) of $163 billion-- from a **profit** of $61B on March 8, 2000 to a **loss** of $102B on March 28, 2001.

Chart 2 also shows that investors in **Aggressive Growth/Tech Specific Sector funds have been hit far worse than other mutual fund investors – and far worse than the decline in the NASDAQ would suggest.** Investors in these funds have displayed a breath-taking sense of bad timing – they literally piled in near the NASDAQ peak and have not sold meaningfully since. Their average cost still remains around NASDAQ 3,600!

Over this same period, these funds averaged only 22% of the assets in all domestic equity mutual funds, but they accounted for over 43% of the decline in unrealized profits in **all** domestic equity mutual funds!

Where Is the Tech Fund Selling?

We constructed these average cost charts to show that the losses in domestic equity mutual funds mirror the performance of the sectors of the S&P 500 as we outlined in Part 1. That is, the Tech sector has doled out tremendous pain while the rest of the market has "held together."

If the public is sitting on huge losses in the Tech sector, why haven't they sold en masse? We believe there are two possible explanations.

First, our data only goes back to December 31, 1996. Had we had data back to October 1990 (like Chart 1), it is possible that the public is still holding onto slim gains in these funds. This would suggest that the selling is yet to come.

Second, these investors have "blown their chance" to sell and now view these funds (stocks) as "lottery tickets." They have taken such huge losses that they do not see the point in selling now. They might even be hoping for a "dead cat" bounce.

We believe that investors still holding these funds (stocks) do view them as "lottery tickets." The losses already taken by the investors who entered in the last stages of the tech mania (the period covered in Chart 3) are so great that this alone should have triggered massive outflows. Yet it did not.

What evidence do we have of this "lottery ticket" mentality? Chart 3 shows that the Aggressive Growth/Tech Specific Sector Funds were beginning to see meaningful outflows in early January. Then these outflows disappeared with the market rebound in mid-January. Now that the NASDAQ is at much lower lows, we are not seeing nearly the outflows that we saw in early January. This suggests that the capitulation took place in December/January.

In reality, the "lottery ticket" concept is more bearish than the panic selling or "capitulation selling" concept. If Tech funds were to see massive outflows, one could argue the bear market was ending. Investors would be realizing losses and walking away from the sector. This would leave these funds/stocks with new investors that bought at much lower prices and without the emotional pain and anguish of riding these stocks lower. Rallies would mean profit (rather than paring of losses) and could attract other investors hoping for profit as well.

Instead, if investors are holding these stocks as "lottery tickets," it could be many years before a meaningful recovery occurs. Every uptick in these stocks will be netted against their substantially higher purchase price. This means any rally just brings a slight reduction in their pain – hardly the stuff to inspire other investors to run into these stocks/funds. Only when the pain of these losses subsides from one's memory will a rally inspire "greed" among these "lottery ticket" holders.

The "Reverse Wealth Effect" – Is it Over?

The "lottery ticket" mentality also has consequences for the economy and the bond market**. We believe it means that the "reverse wealth effect" is essentially over for the holders of these stocks.** By "reverse wealth effect" we mean, the negative impact of plunging stock prices on the economy. The destruction of wealth **has occurred** (past tense) and these investors, sensing that these funds/stocks are no longer going to be supplements to their income, **have adjusted** (past tense) accordingly.

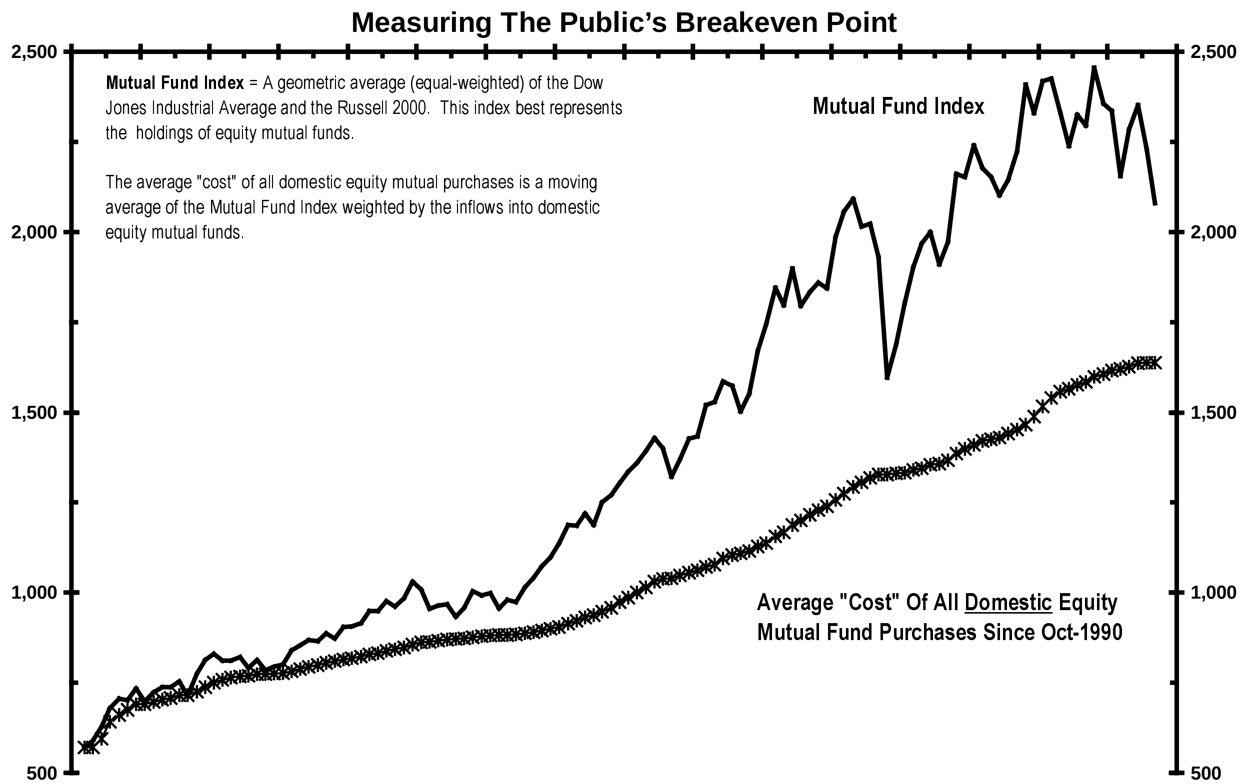
This does not mean that a huge "reverse wealth effect" cannot still occur – it can. It would have to come from non-tech stocks taking a big hit. This means the potential for an additional "reverse wealth effect" has moved from the NASDAQ to non-tech stocks. Currently the vast majority of non-tech stocks are **not** in a bear market.

The Bond Market's Reaction

Many have commented on how the bond market does not seem to react to a dive in the stock market. We believe the bond market is sensing that a major prop for economic weakness, the "reverse wealth effect," is dissipating. Should non-tech stocks come under attack, we would look for further strength in the bond market. The link between bonds and stocks still exists, it has just moved from tech stocks to non-tech stocks.

In Part 3 we will discuss non-tech stocks and Fed policy.

Chart 1


Measuring The Public's Breakeven Point
Mutual Fund Index = A geometric average (equal-weighted) of the Dow Jones Industrial Average and the Russell 2000. This index best represents the holdings of equity mutual funds.
The average "cost" of all domestic equity mutual purchases is a moving average of the Mutual Fund Index weighted by the inflows into domestic equity mutual funds.
Mutual Fund Index
Average "Cost" Of All Domestic Equity Mutual Fund Purchases Since Oct-1990
2,500
2,000
1,500
1,000
500

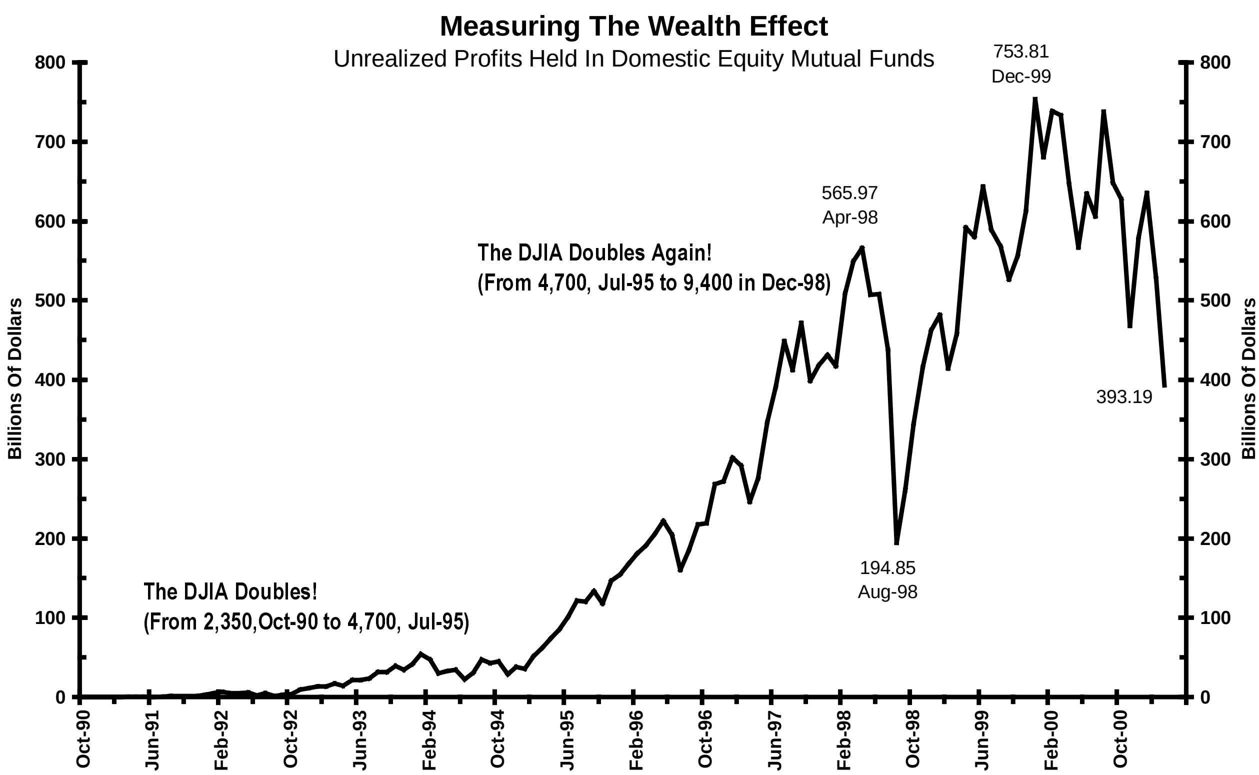
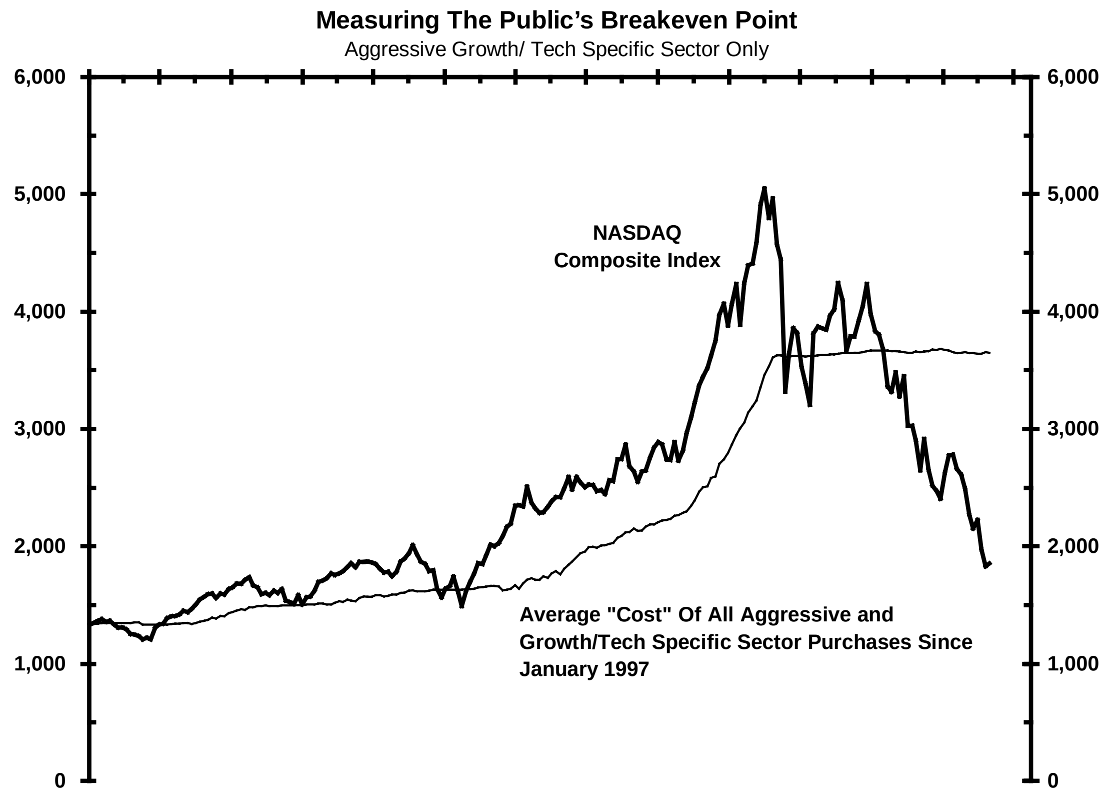

Measuring The Wealth Effect
Unrealized Profits Held In Domestic Equity Mutual Funds
Billions Of Dollars
753.81
Dec-99
565.97
Apr-98
The DJIA Doubles Again!
(From 4,700, Jul-95 to 9,400 in Dec-98)
393.19
194.85
Aug-98
The DJIA Doubles!
(From 2,350,Oct-90 to 4,700, Jul-95)
800
700
600
500
400
300
200
100
0
Oct-90
Jun-91
Feb-92
Oct-92
Jun-93
Feb-94
Oct-94
Jun-95
Feb-96
Oct-96
Jun-97
Feb-98
Oct-98
Jun-99
Feb-00
Oct-00

Chart 2


Measuring The Public's Breakeven Point
Aggressive Growth/ Tech Specific Sector Only
NASDAQ
Composite Index
Average "Cost" Of All Aggressive and
Growth/Tech Specific Sector Purchases Since
January 1997
6,000
5,000
4,000
3,000
2,000
1,000
0

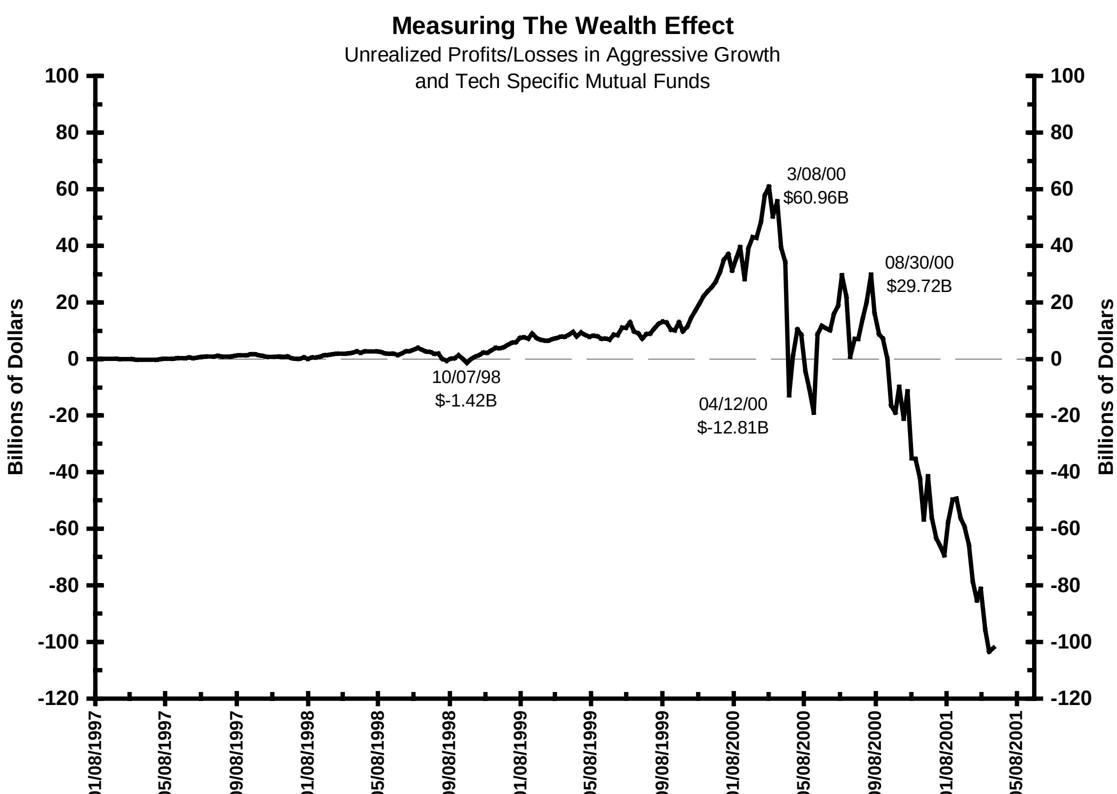
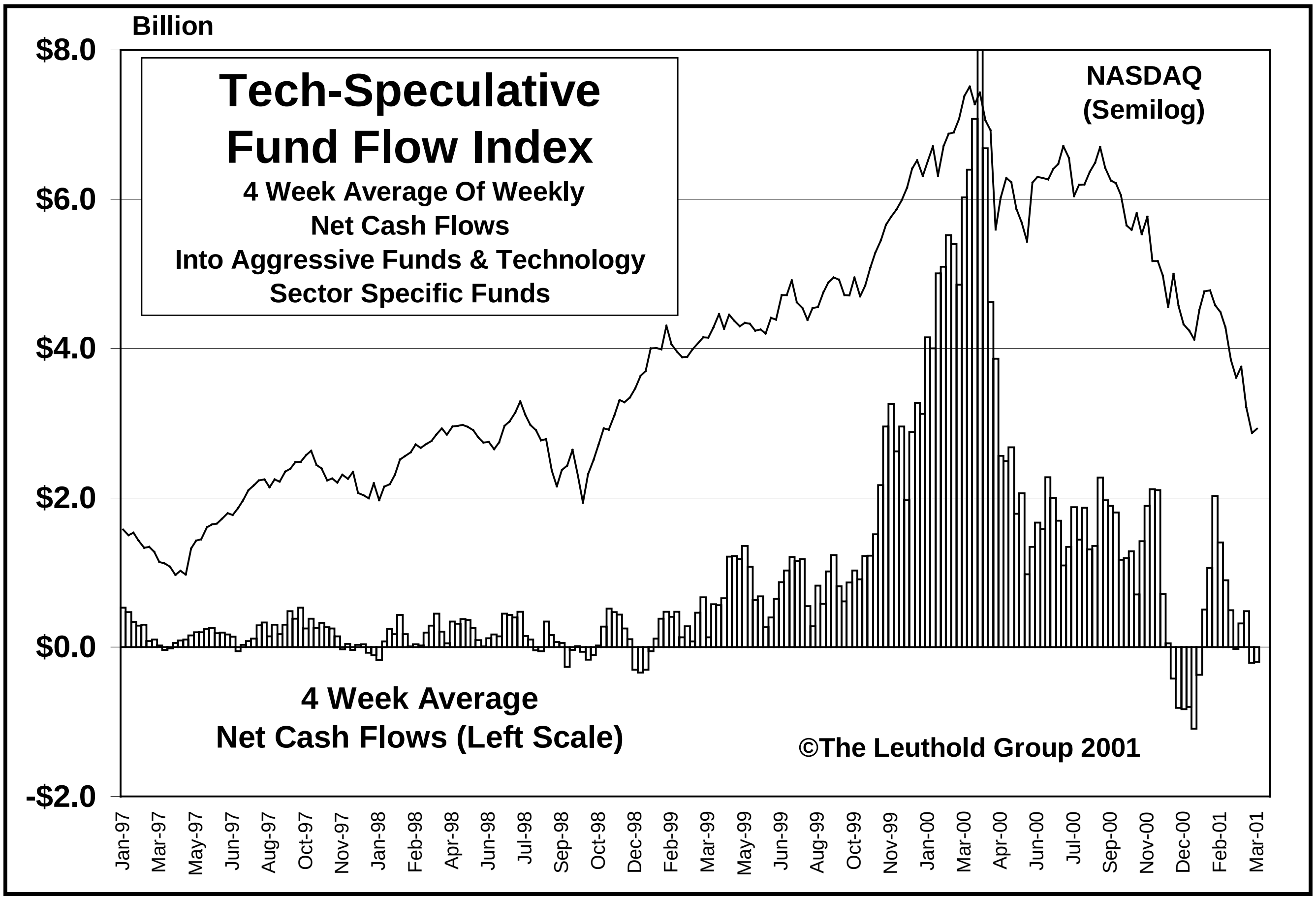

Measuring The Wealth Effect
Unrealized Profits/Losses in Aggressive Growth
and Tech Specific Mutual Funds
3/08/00
$60.96B
08/30/00
$29.72B
10/07/98
$-1.42B
04/12/00
$-12.81B
Billions of Dollars
100
80
60
40
20
0
-20
-40
-60
-80
-100
-120
01/08/1997
05/08/1997
09/08/1997
01/08/1998
05/08/1998
09/08/1998
01/08/1999
05/08/1999
09/08/1999
01/08/2000
05/08/2000
09/08/2000
01/08/2001
05/08/2001

Chart 3


Billion
$8.0
$6.0
$4.0
$2.0
$0.0
-$2.0
Tech-Speculative
Fund Flow Index
4 Week Average Of Weekly
Net Cash Flows
Into Aggressive Funds & Technology
Sector Specific Funds
NASDAQ
(Semilog)
4 Week Average
Net Cash Flows (Left Scale)
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Jan-97
Mar-97
May-97
Jun-97
Aug-97
Oct-97
Nov-97
Jan-98
Feb-98
Apr-98
Jun-98
Jul-98
Sep-98
Oct-98
Dec-98
Feb-99
Mar-99
May-99
Jun-99
Aug-99
Oct-99
Nov-99
Jan-00
Mar-00
Apr-00
Jun-00
Jul-00
Sep-00
Nov-00
Dec-00
Feb-01
Mar-01