

## The Large-Cap/Tech Bubble (1996-2000)

### *From Our Quarterly Letters*

Letter Date	Quote from Quarterly Letter	After-Events Comment
Q3, 1996	<p>“Given the recent popularity of stocks, and especially growth stocks, it is worth pondering human nature. The proliferation of investors buying many growth stocks today . . . is not entirely unrelated to the proliferation of individuals wearing Nike labels. People want to belong in a group, and derive a feeling of safety and emotional support from doing so. By imitating others we make popular choices, which creates momentum as the group grows and others imitate. But behavior based on imitation is behavior without conviction, and is therefore fickle and unreliable. . . . We remain committed to purchasing companies that offer long-term growth, but we are also wedded to a valuation discipline that prevents us from following the crowd . . .”</p>	<p>Our valuation discipline prevented us from following the crowd – whose behavior ultimately led to losses for so many.</p>
Q1, 1997	<p>“For the past 2 years, investors have poured more and more money into stocks.... regardless of their valuations... This strategy works well while prices are rising and new buyers are enticed.... But when prices fall...the music stops...and investors realize they paid peak prices during the euphoria. Our approach is the opposite of this, and is more aptly described as ‘buying straw hats in winter’ ”.</p>	<p>The momentum market was in full swing, and our “value-oriented” discipline was irrelevant in such a market. 3 years would pass before investors realized the truth of these words.</p>
Q3, 1997	<p>“If investors expect these high rates of return in the future, they are sure to be disappointed. This may be seen by examining the mathematics of today’s high P/E ratios and long-term earnings growth . . . if the P/E ratio falls to 15, the 10-year return will only be 3% per year. If the P/E ratio falls to 15 within 5 years, the return (of the S&amp;P 500) would be –3% per year. Moreover, the market’s P/E has been below 15 in 62% of past years. This suggests there is a better than even chance that investors in the S&amp;P 500 today will earn 3% or less per year over the next 10 years.”</p>	<p>Over the subsequent 5 years, P/E ratios did fall to about 17, and the S&amp;P 500’s return was –1.6% per year. The S&amp;P 500’s return since this letter, through May 31, 2009, was 1.5% (annualized).</p>
Q4, 1997	<p>“The causes of financial crises such as in Asia are similar from generation to generation, and fairly predictable. Overconfidence leads to over-investment financed by aggressive lending. Easy money fuels poor investments and eventually loans cannot be repaid. Banks begin to fail and depositors rush for safety. Chance, political tensions, and survival instincts combine so that some financial crises prove to be summer storms, while others set in like Chicago winters. .... We have no magic formulas, but principles we believe are sound. .... We will adhere to these principles as events unfold.”</p>	<p>This comment about the Asian crisis proved equally applicable to the US 10 years later.</p>
Q4, 1998	<p>“The S&amp;P 500 is viewed as a neutral investment approach, where one owns “the market”. This is no longer true. Instead, the S&amp;P 500 has become a heavy “style” bet on large, high growth, high priced companies . . . . History has shown this to be a “fair weather” strategy that is dangerous, and we will not invest this way”.</p>	<p>A commitment to a strong price discipline was necessary to limit the risks of a top-heavy market.</p>

### EQUITY INVESTMENT CORPORATION

GROWTH IS OUR OBJECTIVE \* PRICE IS OUR DISCIPLINE \* QUALITY IS OUR FOUNDATION

## The Large-Cap/Tech Bubble (1996-2000)

### *From Our Quarterly Letters*

Letter Date	Quote from Quarterly Letter	After-Events Comment
Q1, 1999	<p>“Given the continued under-performance of mid and small companies, we both must answer the question: Why do we own them instead of the big companies? The answer can best be understood by a story. In his book <u>Into Thin Air</u>, Jon Krakauer relates the tale of two guides leading relatively low-skilled climbers up Mount Everest. Each guide was competing for highest performance (defined as “getting to the top”), because that meant more publicity and more patrons willing to pay \$50,000 guide fees. Each guide faced a dilemma: patrons paying such fees expected to “get to the top”, but the capriciousness of high-altitude conditions sometimes means turning back for safety before reaching the summit...Unfortunately, the competing guides led novices to ever higher heights (but greater risks), and ultimately did reach the summit. But they did so by ignoring their own preset decision rules on “latest safe turnaround” times, as well as other grave risks. Too late to get down safely, they perished, along with a number of their clients, as an unnoticed storm came from below to engulf the expedition.</p> <p>“Today’s large stocks and “Top 10 Contributor” stocks are at high altitudes. Rather than ignoring our preset decision rules of value and prudence, we turned back from these holdings, knowing the risks of high prices. That is why we hold so many reasonably priced mid and small cap companies today. I expect to “get to the top” over a full investment cycle, but I also plan to be a survivor. I believe this is the right attitude for your investment guide to have.”</p>	<p>This statement aptly laid out the risks of investing in the overpriced stocks leading the market upward in 1999. Within 12 months, investors would begin to see the risks more clearly, but in all too many cases, they did so too late to avoid the significant losses that were soon to come from unforeseen “storms”.</p>
Q4, 1999	<p>“I have no idea how long the high P/E stocks will continue to outperform, nor does anyone else. I can say, however, that owning high P/E stocks has not been a sound <b>long-term</b> investment strategy. ... There have been periods when high P/E stocks outperformed, but these periods have been short lived. Therefore, we do not plan to change our approach.”</p> <p>“...Our competitive and rapidly changing world economy makes it difficult for any company to sustain growth unchecked. <b>Inevitably growth stories that seem unstoppable prove vulnerable with time.</b> Therefore, a dose of realism, or conservatism, should be applied when projecting a company’s future growth, and in determining its Value, and the price one is willing to pay.”</p>	<p>As 1999 closed, the mania for growth stocks, particularly technology and internet stocks, was reaching its climax. As money flow moved away from value managers, toward high P/E growth investors, it became increasingly difficult for value managers to stick to their disciplines. Most of the growth stories that appeared inevitable in 1999 proved to be vulnerable with time.</p>
Q3, 2000	<p>“For several quarters we have discussed the upside-down nature of the market, namely, that the stocks with the highest P/E ratios were rising, while low P/E stocks were falling...The question is whether these prices (of high P/E companies) are justified by the high growth opportunities among new technologies, or whether they represent another example of over-optimism. The 1920’s witnessed a similar debate, as new technologies created dramatic improvements in productivity... These improvements resulted in unparalleled growth (and as a side-note, expectations of large federal government surpluses to come). <b>In retrospect it is easy to look at the 1920’s as mania-driven and forget the compelling visions of growth that must have provided rational-izations for the prevailing high prices. The same will probably prove true of today.”</b></p>	<p>The <i>rational-izations</i> for high prices, namely expectations of unending growth, did prove to be overly optimistic extrapolations (as were the hopes for future government surpluses).</p>

### EQUITY INVESTMENT CORPORATION

GROWTH IS OUR OBJECTIVE \* PRICE IS OUR DISCIPLINE \* QUALITY IS OUR FOUNDATION