Patrick Grady
Globe and Mail
February 1, 1982, p.B4.

Why are stock buyers so unreasonable?

Economists have always been intrigued by the stock market. David Ricardo, perhaps the greatest classical economist, was himself a stockbroker. John Maynard Keynes' success in the market was legendary.

Starting with a few thousand pounds, and after escaping from a near brush with bankruptcy, he left an estate valued at about 450,000 pounds in 1946. Mr. Keynes' secret? Staying in bed an extra half hour every morning.

From atop his cushioned trading desk he would ruminate overbalance sheets and pertinent items of economic intelligence. The ritual would be completed with a phone call transmitting the day's buy and sell orders.

Mr. Keynes' financial sagacity not only established his own personal position as a man of wealth but enriched his college at Cambridge. As bursar, he parlayed King's College's small fund of 30,000 pounds into 380,000. Even Mr. Keynes, however, did not turn everything he touched into gold.

Paul Samuelson, a Nobel laureate in economics and something of an investment phenomenon in his own right, relates that an account in his textbook of Mr. Keynes' victories. on the fields of finance moved a professor from Birmingham to write a letter complaining ·that "it's all very well for you to say that, but Mr. Keynes lost a fortune for me. I invested in his investment trust and was -cleaned out. "

An alternative

Economists as a group are prone to look at the stock market from a fundamentalist point of view. Like Mr. Keynes, they study financial reports and attempt to anticipate future trends and profits.

An alternative is the technical approach. Its practitioners scrutinize stock price and volume charts for tell-tale signs such as head and shoulders configurations, triple tops, and pennants and groups. These guide their buy and sell recommendations.

The most conspicuous of the technicians is Joseph Granville: a great showman. Gullible followers, hanging on his every word, are sufficiently numerous to move the market up or down following his melodramatic pronouncements.

To economists, this all smacks of hocus-pocus. The technical approach comes in their hierarchy of scientific theories at about the same level as divination by examining the entrails of sacrificial animals. Indeed, some might even go so far as to suggest that the patterns sought bear some similarities.

Mr. Keynes himself recognized the limitations of rational analysis of stock market values. He characterized conventional valuation "as the outcome of the mass psychology of a large number of ignorant individuals." This forced even professional investors to focus on the basis of conventional valuation months.hence, rather than on the long term yield.

Mr. Keynes likened professional investment analysis to a newspaper competition in which the competitiors had to choose the six prettiest faces from a hundred photographs, with the prize going to the competitor whose choice was not the best but closest to the average.

The rational basis of stock market valuation was called into question by Franco Mdigliani of the Massachusetts Institute of Technology and Richard Cohn of the University of Illinois in a 1979 article in the Financial Analysts Journal.

Since that time, a controversy been raging in the investment community. Mr. Modigliani restated his case at an Economic Council of Canada conference in Toronto recently.

In spite of the fact that equities supposed to be a hedge against inflation, stock prices have not kept pace with inflation, he said. Since 1968, the Standard and Poor's stock price index has risen only 30 per cent, whereas broad price indexes have gone up about 150 per cent.

He attributed the stock market's poor performance to the lack of understanding among market participants of the correct valuation procedures to be applied in an inflationary environment. This is nothing less than heresy to those who like to believe that markets are efficient.

Mr. Modigliani argues convincingly that analysts err when they use nominal rates incorporating an inflation premium to capitalize future profit streams.

Instead, the correct procedure would be·to capitalize·using a real rate, which excludes the inflation premium. This would take into account that equities represent a claim on real assets and the related real income stream and are not significantly affected by inflation.

Mr. Modigliani also put forward a further reason why inflation might have had an adverse impact on stock market values. It is that participants may have failed to correct profits properly for the gain on the inflation-induced depreciation of monetary liabilities.

The upshot of this analysis is that stocks are currently trading in the United States at about half the level that would be consistent with rational valuation procedures. Prudently, Mr. Modigliani hesitates to predict that the market will stage a recovery to this higher level. The market may continue to function like Mr.Keynes' beauty contest.

Canadian data

At the same conference, John Grant, chief economist for Wood Gundy Ltd. of Toronto, examined Mr. Modigliani's hypothesis using Canadian data. He stressed that, in contrast to the U.S. experience, Canadian equities, have generally kept ahead of inflation.

A model built at Wood Gundy was said to satisfactorily explain the movements of the Toronto Stock Exchange's composite index without having to suggest irrational behavior by market participants. " .

The impact of inflation on Canadian stock market values is, however, clouded by the greater weight of oil and gas stocks in the Canadian index.

So, investors who are tempted to go into hock to lunge into the market in anticipation of the happy day when' rationality triumphs and stock. prices ,double overnight should bear in mind the sad plight of the professor from Birmingham.