"The Stock Market: A Zero-Sum Game?"

> How much is enough? It's not a question of enough, pal. It's a zero-sum game. Somebody wins and somebody loses. Money itself is not lost or made; it's simply transferred ...
>
> Gordon Gekko, *Wall Street*, 1987

The waves of corporate scandals in the U.S. continue to dominate the financial news. In 2001-2002, it was the Enron, Arthur Andersen and WorldCom scandals. Then it was the insider trading story of ImClone CEO, Sam Waksal, (now in jail) and his friend, Martha Stewart (indicted, but not convicted). Next came the revelations that research analysts of several leading investment houses had touted particular stocks (whose prospects were questionable) in order for their investment banking colleagues to win investment banking business from these firms. This year we have learned about the outlandish compensation package of Dick Grasso, CEO of the New York Stock Exchange, and the mutual fund trading irregularities. The media has used each new revelation and ensuing scandal to call for needed reform. They have also, however, used these stories to cast doubt on our economic system and on the stock market. If an investor were to believe many of the media reports and Hollywood (ever more closely intertwined), the stock market is rigged against the average investor. In fact, they make it appear as if an investor has a better chance of earning a good return on capital at the race track or the gaming houses of Las Vegas or Foxwoods than investing in the U.S. stock market. Although the stock market is up nicely so far this year, surveys show that the average retail investor has believed some of these reports and, having lost serious money during the bear market, has not yet returned to the stock market.

A Zero-Sum Game?

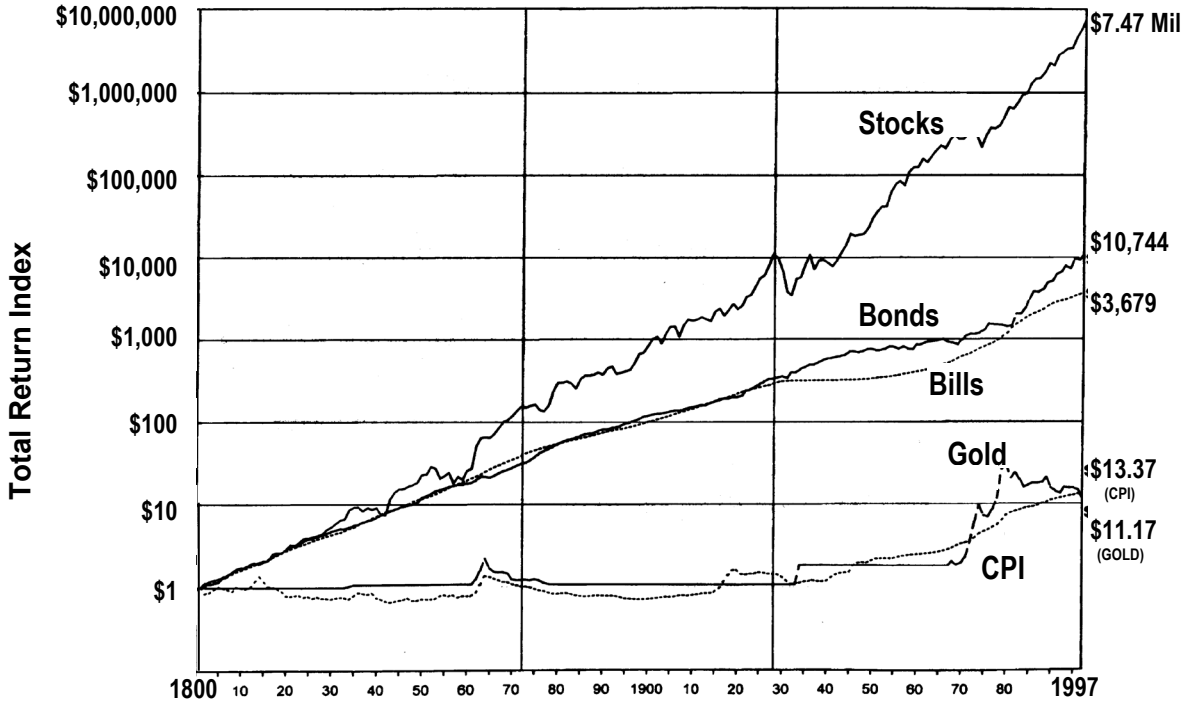
Increasingly, Americans get their news from TV and radio rather than from newspapers and the print media. Likewise, a growing number of Americans have their views about society and culture shaped by the movies which Hollywood produces rather than by books and literature. Thus, many have been influenced by financier and stock operator, Gordon Gekko, in the movie *Wall Street,* produced by Oliver Stone in 1987. Students arriving at business schools this fall know all about Gordon Gekko and his speech that the stock market (and our economy) is a zero-sum game. Gordon Gekko (and his creator Oliver Stone) have become part of our vocabulary and our culture.

Before analyzing his assertion, it is important to define the concept of a zero-sum game. This is a term coined several decades ago by academicians who were involved in game theory. A good working definition found on Investopedia.com defines a zero-game as "a situation in which one participant's gains result only from another participant's equivalent losses. The net change is always 0." A good example of a zero-sum game is a poker game. There is a fixed amount of money in the game, and the sum of all participants' winnings always equals the sum of all participants' losses.

But, is the stock market a zero-sum game? Does one investor's gain equal another's loss? Is investing simply a process of transferring money from the losers to the winners? The simple and accurate answer is no. While it is certainly possible to lose money in the stock market on individual trades of stocks or investing in a basket of stocks via a mutual fund, it is also possible to make money on individual stocks or a mutual fund. Here is a simple example (using actual share prices and dates) that shows why the stock market is not a zero-sum game but rather a positive-sum game (where the whole pie grows rather than where the pie stays fixed): An investor buys 1,000 shares of Johnson & Johnson stock at $10 per share in 1994. A year later, the shares are sold to another investor at a price of $15 a share. This investor sells the same 1,000 shares to another at the end of 1996 for $20 per share who, in turn, sells the same shares to another investor at the end of 1997 for $30 per share (the price of JNJ is currently trading around $50 per share). Each investor has made a nice capital gain on the purchase and sale and collected dividends for a year as well. Clearly not all transactions show a gain, as it is all too easy to buy high and sell low. But the key point is that a gain by one investor is not an automatic and equal loss for another investor – too often the way that the movie *Wall Street* and much of the media portray the stock market.

The Long View

To make serious money in the stock market, the best way to arrange the odds in one's favor is to take the long view. A $1,000 investment in the S&P 500 Index just before the crash in October, 1929 would be worth approximately $750,000 today (assuming these stocks or similar S&P 500 stocks are held through thick and thin, reinvesting the dividends in the same stocks). An increase of 750 times in 74 years. Perhaps a more recent example is useful: From August 12, 1982 through September 30, 2003, the S&P 500 Index, with dividends reinvested, turned $10,000 into approximately $160,000. The following chart tells the story best:



The 2003 Bull Market

Stocks in the broad-based S&P 500 Index are about 34% higher now than they were at their low on October 10, 2002. With the Iraq invasion looming in mid-March of this year, stocks re-tested their October, 2002 lows and then reversed course rapidly during the spring and early summer. Most of the gains of this bull market were made during this period, although the broad market is up about 5% from July 1, 2003 through October 23, 2003. At this point in October (always a volatile month as mutual funds close out their tax year this month), the Dow Jones is up 15% for the year. The technology-laden NASDAQ Composite, having fallen 78% from the March 2000 peak to its trough in 2002, has bounced back 41% this year. With interest rates beginning to climb this year, the total return of the ten-year U.S. Treasury bond is about flat for the year-to-date. U.S. Treasuries with shorter maturities have returned 1-2% so far this year, while the yields on money market funds are less than 1%. So the stock market has been the place to make money this year, confounding those investors who took money out of stocks to make a higher and safer return in bonds during these uncertain times.

Basic Premises of the Bull Market

This bull market is predicated upon the assumption that the strong monetary and fiscal policies that are being undertaken will cause, as they have in the past, a moderate U.S. economic recovery to turn into a strong one. Although GDP growth for the third quarter has not yet been released, anecdotal information from numerous third quarter earnings releases point to GDP growth of 5% or more this quarter. This news comes from big companies as diverse as Intel, Citigroup, and IBM. With the economy starting to accelerate, profits from companies in the S&P 500 Index during the third quarter of 2003 will likely be up 15% over the third quarter of 2002, and fourth quarter profits are forecast to rise almost 20% over corporate profits a year ago. This should result in a virtuous cycle of more business spending, greater job creation, and higher consumer spending, leading to continuing economic growth in 2004 and beyond.

Investor confidence in strong economic and corporate growth next year is based upon the following premises:

- Continuing low inflation and low interest rates
- Strong monetary stimulus to the U.S. banking system, creating good levels of liquidity
- The powerful effect on consumers and businesses of lower taxes on income, dividends and capital gains
- The large U.S. fiscal deficits in 2003 and 2004, which will help prime the pump and get the economy into high gear
- The estimate that the risk of major terrorist attacks on U.S. soil has been reduced by our troops on the offensive in Iraq and Afghanistan

Risks to the Bull Market Scenario

What can derail this positive bull market scenario? There is always a risk that something will go wrong and turn a bull market into a bear market. Currently we believe the main risks are as follows: interest rates, possible overvaluation, geo-political threats, and election year uncertainty.

Interest Rates: Strong economic growth should cause interest rates to rise, and if interest rates rise too fast next year (perhaps to 5.5-6% on the ten-year U.S. Treasury bond), this could cause stock market valuations to contract. It could also hinder the flow of funds from low-yielding bonds and money market funds to the stock market, where higher after-tax yields are currently available.

Possible Overvaluation: With inflation at 2%, a market multiple of 18 on the Dow Jones and S&P 500 Index 2004 operating earnings provides room for 6-10% price appreciation next year. For example, the projected operating earnings for the Dow Jones Industrial Average in 2004 is $575. Using a P/E multiple of 18, this translates into a Dow Jones valuation of 10,350 – an increase of 9% from the Dow's current level. If interest rates were to rise well beyond 5%, a market multiple of perhaps 16-17 might be more appropriate. This would cause the Dow to stagnate or perhaps even drop in value.

Geo-political Threats: Terrorism by radical, militant Muslims is always a threat to the U.S. and to Western civilization. While the U.S. is better prepared now to counter the threat of terrorist attacks on U.S. soil than it was two years ago, there is always a degree of risk that an incident might occur here. Also the geo-political situation in Israel and Palestine is not improving, and a major flare-up there is always possible. This is why each investor has to determine how much short-term volatility a given portfolio can endure, and adjust the asset allocation to accommodate his or her risk/reward profile.

Election Year Uncertainty: Much of the optimism for a stronger economy and an improving stock market over the next several years is based upon an assumption of lower taxes on investors, families and corporations. If that premise were to be thrown into doubt next year, the stock market would probably stall or even decline, while investors awaited the electoral outcome in November 2004. For example, in 1994, a combination of rising interest rates and an uncertain election caused the stock market to stagnate all year until the November election returns were in, at which time the stock market took off.

The Long Haul

The reason why we frequently publish long-term charts of the stock market is that it is so important for investors, in the midst of short-term risks and uncertainties, to maintain the long-term perspective. The stock market is neither a zero-sum game nor a game rigged by the professionals against the average investor. It is rather a money-making machine for those investors who have the wisdom to own quality, growth stocks and have the courage to hold onto them when some are acting like Chicken Little.

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